Volume X Number 1

MISSISSIPPI LAW JOURNAL

DECEMBER, 1937

Published Four Times Yearly By

University of Mississippi Law School

and

Mississippi State Bar

LEADING ARTICLES

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Entered as second class matter at the Post Office at University, Mississippi, with additional entry at the Post Office at Meridian, Mississippi, November 25, 1936.

Published four times a year: September, December, February, and April.

$3.00 PER ANNUM - - - - - - - - - 75 CENTS PER NUMBER

Editorial and Business Office - - - - - - - - UNIVERSITY, MISS.

Mississippi Law Journal

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IN RECOGNITION of his valued contributions to the University of Mississippi, the School of Law and the legal profession, and in appreciation of his services to this publication the Editors respectfully dedicate this Tenth Anniversary Volume of the Mississippi Law Journal to the memory of

JUDGE WILLIAM HEMINGWAY

July 19, 1869 — November 6, 1937

Mississippi Law Journal

JOURNAL of the MISSISSIPPI STATE BAR

VOL. X DECEMBER, 1937 No. 1

THE COURTS AND DUE PROCESS OF LAW*

Sydney Smith†

I shall not indulge in any technical discussion of due process, but will deal with it in a broad outline only, and simply call the reader's attention to some questions for his consideration, should he desire to pursue the matter further.

The relation of the courts to the due process of law clause of our constitutions, and the method by which they have arrived at their conclusion of its meaning and purpose, is most interesting.

The vagueness of the phrase "due process of law" necessarily imposes on the courts the burden of developing its true concept and content; in other words, of saying what it means. Mr. Justice Stone, in a recent dissenting opinion, said, "While unconstitutional exercise of power by the executive and legislative branches of government is subject to judicial restraint, the only check upon our own exercise of power is our sense of self restraint."[1] Mr. Justice Sutherland subsequently characterized this statement as "both ill considered and mischievous."[2] One may easily disagree with this criticism. Be that as it may, when other provisions of the Constitution are under consideration, this statement of Mr. Justice Stone unquestionably applies to the court's development of the concept and content of the phrase, "due process of law." The words of the phrase, to borrow the apt and striking language of Judge Learned Hand, in another connection, "are empty vessels into which he [the judge] can pour nearly anything he will," "with no guide," according to Mr. Justice Holmes, "but the court's own discretion."[3]

Another fact, which will hereinafter appear, that lends interest to the study of this subject, is that the court's construction of due process has embedded within it shifting judicial quicksands to avoid which the courts are increasingly being compelled to bend the judicial process almost to the breaking point. The approach of a member of the bar to the problem of the dealing of the courts

*This article was delivered as an address before the Alabama Bar Association at Tuscaloosa, Alabama, July 2, 1937.

†Chief Justice, Mississippi Supreme Court.

[1]297 U. S. 1, 78-79, 80 L. ed. 477, 494-495 (1936).

[2]West Coast Hotel Co. v. Parish, 300 U. S. 379, 81 L. ed. 455 (1937).

[3]Baldwin v. Missouri, 281 U. S. 586, 595, 74 L. ed. 1056, 1061 (1930).

with due process is that of one on the outside looking in. As a member of the bench, I shall discuss it as one on the inside looking out.

It will readily be recalled that the phrase "due process of law" is derived from the words "law of the land" in the 39th chapter of *Magna Carta*, for which the words "due process of law" were substituted in Chapter 3 of 28 Edward III. Both mean the same thing.[4] The first appearance of the phrase in an American Constitution was in the Fifth Amendment to the Federal Constitution; and the courts, while admitting that its language is enduring, have many times pointed out that it is far from being exact. In *Murray v. Hoboken Land & Improvement Company*,[5] it was said: "The Constitution contains no description of the processes which it was intended to allow or forbid. It does not even declare what principles are to be applied to ascertain whether it be due process." This being true, the courts might very well have applied to it the quietly ignored and now forgotten rule announced in 1800, in *Cooper v. Telfair*,[6] that "The general principles contained in the Constitution are not to be recognized as rules to fetter and control, but as merely declaratory and directory." This would have brought the phrase, insofar as it applies to legislative power, into accord with its status in the common law of England, from which our system of jurisprudence is derived.

Once the courts had departed from this rule by holding that the phrase is a restriction on, and not a guide to, the exercise of governmental power, it necessarily followed that it is a restriction not only on executive and judicial power, but on legislative power also. On its face the phrase appears to apply only to procedure; that is, to the actual process by which one is deprived of life, liberty or property. For more than fifty years after the adoption of our first constitutions the cases brought by the courts within the constitutional requirement of due process involved questions of procedure only, the restriction was generally supposed to apply only thereto, and it was not until the 1850's that the courts began to bring substantive law within it. This was first done by the Court of Appeals of New York in 1855.[7] In 1856 Chief Justice Taney, with whom three of his associates seem to have concurred, said that the statute known as the Missouri Compromise "could hardly be dignified with the name of due process of law."[8] It was also

[4] 2 Co. Inst. 50; Murray v. Hoboken Land & Improvement Co., 59 U. S. 272, 15 L. ed. 372 (1856); Twining v. New Jersey, 211 U. S. 78, 53 L. ed. 97 (1908).

[5] 59 U. S. 272, 274, 15 L. ed. 372 (1856).

[6] 4 U. S. 14, 18, 1 L. ed. 721 (1800).

[7] Wynehamer v. People, 13 N. Y. 378 (1856).

[8] Dred Scott v. Sanford, 60 U. S. 393, 15 L. ed. 691 (1857).

applied in the first of the *Legal Tender Cases*,[9] but that case was afterwards overruled.[10]

The courts encountered little difficulty in bringing the taxing and eminent domain powers within the limitations of due process, but whether it was a limitation on the police power seems to have presented a more difficult question. Considerable judicial dicta indicated that the Supreme Court of the United States would bring this power within the limitations of the phrase, but it was probably not until 1894 that it finally and definitely so held.[11] The courts were driven, or thought they were, to bring substantive law within the limitations of due process, for the reason that with increasing frequency they were confronted with statutes said to violate natural justice, vested rights and the fundamental principles of free government, which seemed not to violate any of the other provisions of the constitutions.

An all inclusive and exclusive definition of due process of law cannot be framed. It was absolutely necessary, however, for the courts to find some standard by which to test the validity of statutes challenged under the requirement. This they finally did. The formula therefor, when statutes dealing with substantive law are under consideration, is simply this: The government, state or national, is without the right to deprive any person of life, liberty or property by an act that has no reasonable relation to any proper governmental purpose, or which is so far beyond the necessity of the case as to be an arbitrary exercise of governmental power.

I come now to the shifting judicial quicksands embedded in the phrase "due process of law." *Marbury v. Madison*[12] presented a very simple problem, one of law only, and of the character which the judicial process is fully competent to solve. There all the court had to do was to lay the statute alongside the constitution, and if on its face it was in conflict therewith, to so hold and refuse to enforce it. Such is usually the case when a statute is challenged on the ground that it violates any of the specific provisions of the constitution, but generally under the due process clause, the problem of whether a statute presents a reasonable exercise of legislative power is purely a question of fact, the relevant facts being of a social, economic or political character. Though they have struggled therewith, the courts have not yet succeeded in developing a satisfactory technique for discovering and evaluating the facts on which the reasonableness of a statute rests. For a long time they have looked only to such social, economic and political facts of

[9]Hepburn v. Griswold, 75 U. S. 603, 19 L. ed. 513 (1870).
[10]Legal Tender Cases, 79 U. S. 457, 20 L. ed. 287 (1871).
[11]Reagan v. Farmers Loan & Trust Co., 154 U. S. 362, 38 L. ed. 1014 (1894).
[12]5 U. S. 137, 2 L. ed. 60 (U. S. 1803).

which judicial notice may be taken, but within a comparatively recent time it was discovered that in a limited class of cases; *e.g.*, where public officials are sought to be enjoined by a suit in equity from enforcing a statute, these facts could be developed by the trial court. The Supreme Court of the United States is encouraging this practice, and not infrequently remands such a case to the trial court for the development of the facts underlying the reasonableness of a challenged statute, in accordance with Equity Rule No. 70½.[13]

If the burden of determining whether statutes violate due process of law, in matter of substance, is to remain with the courts, one of two things must be done: (1) a procedure for developing the facts relative thereto by trial courts in all cases, including those where the statute is challenged by way of demurrer, must be devised; or (2) the appellate courts must be furnished with commissions charged with the duty of ascertaining such facts and reporting to the courts their findings, not conclusions from the facts, but the facts themselves. But the difficulty is not solved when the court has ascertained these facts. It has only just begun. Experience has demonstrated that comparatively few statutes have been passed that are manifestly unreasonable or arbitrary, and most of those held to violate due process were on or near the borderline of reasonableness. As I have stated above, the test of the validity of a statute under due process is whether it has a reasonable relation to a proper governmental purpose, or as sometimes stated, whether it is so plainly arbitrary and unreasonable that no rational man would think it otherwise. If, on the facts underlying it, rational men could differ as to its reasonableness, it must be held valid. It is *prima facie* valid, and the burden of proving that it is not is on the one who challenges it. If any facts that would justify the statute can be reasonably supposed to exist, it will be held valid. If these rules were rigidly adhered to most, probably all, of the statutes dealing with social justice and economic problems that have been invalidated by the courts would have been upheld. But, human nature being what it is, this cannot be done. Moreover, if these rules could and should be rigidly adhered to, the result would be that the courts would thereby practically surrender their function of determining the validity of statutes under due process. This they have no right to do.

The trouble here is this: It is very difficult, in the borderline cases, for a judge, in the quiet of his study, or of the consul-

[13]Borden's Co. v. Baldwin, 293 U. S. 194, 79 L. ed. 281 (1934); Nashville, *etc.*, Ry. v. Walters, 294 U. S. 405, 79 L. ed. 949 (1935); Hammond v. Schappi Bus Line, 275 U. S. 164, 72 L. ed. 218 (1937); Hammond v. Farina Bus Line, 275 U. S. 173, 72 L. ed. 222 (1937); Chastleton Corp. v. Sinclair, 264 U. S. 543, 68 L. ed. 841 (1934). See also Note (1930) 43 HARV. L. REV. 940.

tation room, far removed from the social, economic and political firing line, without personal knowledge of the problems involved, to determine whether a challenged statute has a reasonable relation to a proper governmental purpose. Generally he can do this only by adopting his own subjective views as the standard of reasonableness; by assuming that he himself is the reasonable man by whose views the statute should be tested. Moreover, in many of the cases wherein statutes have been held to rest on no reasonable basis, the judges of the reviewing court differ among themselves as to the inferences to be drawn from the facts that underlie the statute, thereby demonstrating that reasonable men may so do. It is hard for the man in the street to understand this, and the result is that the right of the courts to determine the reasonableness of statutes is being widely challenged as a usurpation of power resting on an absurd basis. One commentator has gone so far as to say: "Taken seriously, this conception [of due process] makes of our courts lunacy commissions sitting in judgment upon the mental capacity of legislators and, occasionally, of judicial brethren."[14] An exaggeration, of course, probably intended as much in order to sharply call attention to a profound truth at its core.

Theoretically the courts have no control over legislative policy, or with the wisdom of legislation. But the human equation, the bent of the judge's mind, cannot be eliminated from the administration of justice, and in cases involving due process of law, it is very difficult for a judge, however honest he may be, to refrain from testing the reasonableness of a statute by those social, economic and political theories in which he is schooled, and which he believes essential to the peace, prosperity and happiness of the people—by "an idealized political picture of the existing social order."[15] The result is that some cases, as Mr. Justice Holmes has said, are "decided upon an economic theory which a large part of the country does not entertain,"[16] and "prevent the making of social experiments that are an important part of the community desires,"[17] and, according to Mr. Justice Brandeis, present "an exercise of the powers of a super-legislature—not the performance of the constitutional function of judicial review."[18] The truth is that in passing on the reasonableness of a statute, the courts come perilously near determining legislative policy. In fact, they do just that; so much so that in 1930 Senator Borah felt justified in saying on the floor of the senate, "They [the Judges of the Supreme

[14]Cohen, *Transcendental Nonsense and the Functional Approach* (1935) 35 COL. L. REV. 809, 819.

[15]Pound, *The Theory of Judicial Decision* (1923) 36 HARV. L. REV. 641, 656.

[16]Lochner v. New York, 198 U. S. 45, 75, 49 L. ed. 937, 949 (1905).

[17]Truax v. Corrigan, 257 U. S. 312, 344, 66 L. ed. 254, 268 (1921).

[18]Jay Burns Baking Powder Co. v. Bryan, 264 U. S. 504, 534, 68 L. ed. 813, 836 (1924).

Court] pass upon what we do. I say this in great sincerity. We declare a national policy. They reject it."[19] Statements similar to that frequently appear in the literature of this subject. For instance; "As a rule, when the Supreme Court declares a state law unconstitutional under the [Fourteenth] Amendment, what it really does is not to decide a question of law, but a question of governmental policy. The real question is not whether the legislation is legal, but whether it is wise and expedient, the criterion of wisdom being the opinion of a majority of the Supreme Bench."[20]

This burden on the courts where social and economic questions are involved not only presses the judicial process to the breaking point, but when met frequently results, because of popular dissatisfaction therewith, in the undermining of the prestige of the courts and their status as symbols of constitutional surety and stability. The courts should not be subjected thereto, unless the protection of life, liberty and property imperatively demands it. This necessity does not exist, and "appeals for the removal of unwise, harsh and oppressive laws should lie not to the courts, but to the ballot and the processes of democratic government."[21] Relief from this burden could be given to the courts by so amending the due process provision of our constitutions as to confine it, as it was at first supposed to be, to matters of procedure only. No harm would come from this, in view of the other provisions of our Bills of Rights, provided the *ex post facto* provisions thereof be made to apply to statutes of a civil as well as of a criminal nature. Liberty is as safe in England as with us, and there "due process" is not a limitation on legislative power, but is a guide to Parliament in its exercise.

The best argument for continuing to burden the courts with this responsibility that has come under my observation is that made by that great jurist, Mr. Justice Cardozo, in his "The Nature of the Judicial Process," which argument gins down to this: The power of the courts to refuse to obey a statute, for the reason that it unreasonably restricts liberty, can and should be exercised in very few cases only, but the existence of the power "tends to stabilize and rationalize the legislative judgment, to infuse it with the glow of principle, to hold the standard aloft and visible for those who must run the race and keep the faith."[22] In other words, the ex-

[19]Quoted by Senator Theodore Francis Green in *The Supreme Court and the President's Proposal* (1937) 23 A. B. A. J. 422.

[20]COLLINS, THE FOURTEENTH AMENDMENT AND THE STATES (1912) 168.

[21]Mr. Justice Stone in United States v. Butler, 297 U. S. 1, 79, 80 L. ed. 477, 494 (1936). See also Munn v. Illinois, 94 U. S. 113, 134, 24 L. ed. 77 (1877); and Missouri Pac. R. Co. v. Humes, 115 U. S. 512, 520, 29 L. ed. 463 (1885).

[22]CARDOZO, THE NATURE OF THE JUDICIAL PROCESS (1921) 91-94.

istence of the power is a good, for the reason that the threat of its use will hold the legislature within due bounds. With deference I suggest that among a free people the ballot should be sufficient for that.

I must not be understood as challenging the American doctrine of judicial supremacy, which, under our form of government, resting as it does on written constitutions, is absolutely necessary if that form is to be preserved. I am only questioning it when applied to the reasonableness of statutes under due process. When so applied, I have no hesitancy in saying that it does not promote domestic tranquility. Due process of law is not a mere "negative phrase to serve as a barrier to social change;" it is a way of life leading to peace and happiness. Its meaning is, "Whatsoever ye would that men should do to you, do ye even so to them." What is within or without that way can best be determined by those who are to live that life—by the people themselves through the processes of Democratic government.

OPINIONS OF THE SECURITIES AND EXCHANGE COMMISSION*

David Loeb Krupsaw†

In the community of administrative agencies, the Securities and Exchange Commission has rapidly risen to a position of prestige. An important part of the Commission's job is to act as a judicial body and its formal opinions have now grown to the point where an analysis of them can be made with profit. They reveal the Commission's attitude toward the problems it is charged with solving. They indicate to a considerable degree how effectively the statutes entrusted to the Commission's management are being pressed to meet Congressional purpose. They resolve many of the matters necessarily or wisely left to administrative discretion.

The Securities Act of 1933[1]

The broad purpose of the Securities Act of 1933 is "that every issue of new securities to be sold in interstate commerce be accompanied by full publicity and information and that no essentially important element attending the issue be concealed from the buying public."[2] The Act prescribes the procedure which must be followed so that a new-born security may make its entrance into the financial life of the nation.

Matters of Procedure

Under the Securities Act, with certain exceptions, any person or corporation which proposes to offer a new issue of securities for

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*This article omits any consideration of decisions involving the Public Utility Holding Companies Act of 1935. The invaluable aid and advice of Mr. Herbert B. Cohn, of the Office of the General Counsel of the SEC is most gratefully acknowledged. In its original form this study was submitted to Professor Felix Frankfurter in the course on Administrative Law in the Harvard Law School.

†A.B., Harvard 1934; LL.B., Harvard 1937. Member Bar of District of Columbia.

[1]48 Stat. 74 (1933), 15 U. S. C. A. 77 (Supp. 1936). See generally: Douglas and Bates, *The Federal Securities Act of 1933* (1933) 43 Yale L. J. 171; Frankfurter, *The Securities Act: II,* (Aug. 1933) 8 Fortune 53; Bane, *The Federal Securities Act of 1933* (1934) 14 B. U. L. Rev. 35; James, *Amendments to the Securities Act of 1933* (1934) 32 Mich. L. Rev. 1130; Symposium, *Three Years of the Securities Act* (1937) 4 Law and Contemporary Problems, Nos. 1 and 2. The constitutionality of the Securities Act was upheld in Jones v. SEC, 79 F. (2d) 617 (C. C. A. 2d, 1935), *rev'd on other grounds,* 298 U. S. 1, 80 L. ed. 1015 (1936); (1936) 4 Geo. Wash. L. Rev. 286 (1936); 84 U. Pa. L. Rev. 658; Jones v. SEC, 85 F. (2d) 17 (C. C. A. 2d, 1936), *cert. denied,* 299 U. S. 581 (1936); McMann v. SEC, 87 F. (2d) 377 (C. C. A. 2d, 1937); Coplin *et al.* v. United States, 88 F. (2d) 652 (C. C. A. 9th, 1937); Newfield v. Ryan, 91 F. (2d) 700 (C. C. A. 5th, 1937), *cert. denied,* Oct. 18, 1937, *petition for rehearing denied,* Nov. 8, 1937.

[2]*Message of the President to Congress,* H. R. Rep. No. 85, 73d Cong., 1st Sess. (1933) 1.

sale publicly in interstate commerce, must first place in the public files of the Securities and Exchange Commission a statement of information on the securities to be offered. This statement of information is known as a Registration Statement, and must remain on file for a waiting period of at least twenty days before the securities may be offered for sale. An amendment to a registration statement may be filed at any time, subject to the requirement that the registration statement must then remain on file an additional twenty days from the filing of the amendment before registration can become effective.[3] In cases where amendments have been filed, the Commission may by order shorten the additional twenty-day waiting period. In some cases, a number of successive amendments may be necessary before the full story of a proposed security issue can be fairly presented.

When the Commission has reason to believe that a registration statement is materially deficient, it holds a public hearing to determine whether deficiencies actually exist.[4] If evidence produced

[3]Effective registration does not imply "approval" by the Commission of any registration statement or any security issue. The Commission does not pass on the merits of any security registered with it. The fact that registration has become effective is not to be taken as an indication that the Commission has passed on the truth or accuracy of the contents of the statement, or that the securities constitute a sound investment. It is a criminal offense to make representations of this character. See Section 23.

[4]Rule IV(c) of the Commission's Rules of Practice provides that hearings shall be stenographically reported and a transcript supplied to the parties. The demand of witnesses for copies of their testimony in investigations has led to several holdings that the Rule deals with "hearings" and not "investigations." *In re* SEC, 84 F. (2d) 316 (C. C. A. 2d, 1936), *affirming* 14 F. Supp. 417 (S. D. N. Y. 1936); SEC v. Torr, 15 F. Supp. 144 (S. D. N. Y. 1936). The courts have pointed out that an investigation is conducted to decide whether the facts justify the Commission to hold a "hearing" or to bring suit for injunctive relief. The investigation makes no decision between the parties, for there are no parties. Hence the character of the investigations, as a preparatory matter looking to enforcement of the Acts, gives the basis for refusal to grant copies of testimony. The analogy to grand jury proceedings, the records of which are not open to defendants, has been relied on. The denial of transcripts is not a deprivation of due process. It is incumbent on a witness to assert his privileges if he considers that testifying constitutes a violation of his constitutional rights. SEC v. Torr, 15 F. Supp. 144 (S. D. N. Y. 1936). *Cf.* Exchange Act, Section 21(d).

Section 25(a) of the Exchange Act gives a person aggrieved by an order issued by the Commission in a proceeding to which he is a party the right to a review in a circuit court of appeals. Therefore, a district court must dismiss, because of lack of jurisdiction, the bill of a person so aggrieved. And to be reviewable by a circuit court it is necessary that the order be not merely interlocutory, but final. See SEC v. Andrews, 88 F. (2d) 441 (C. C. A. 2d, 1937). Where a registrant had sent a letter to the Commission asking it to amend its rules and the Commission had denied the request, the Second Circuit held that it is without jurisdiction to entertain the registrant's petition to review, since there had been no "proceeding" within the meaning of the Act. The court said that if there had been disobedience in filing reports as required and the Commission had proceeded against the registrant, the latter then might have a right to petition the court for review of the Commission's order. Third Ave. Ry. Co. v. SEC, 85 F. (2d) 914 (C. C. A. 2d, 1936).

at the hearing leads the Commission to the conclusion that the statement is deficient, the Commission may issue a stop order suspending the effectiveness of the registration statement.[5] The effect of a stop order is to render sale of the securities illegal. A registration statement under stop order may at any time be amended to remedy the deficiencies cited in the stop order, in which case the Commission may at its discretion lift the stop order and allow the registration statement to become fully effective. Consent to an amendment is given only upon entry of an order to that effect.[6]

The respondent in a stop order proceeding ordinarily is heard first by a trial examiner. An attorney is not disqualified to conduct hearings as an examiner simply because he is an employee of the SEC.[7] The Commission has provided by rule of practice,[8] and repeated in its decisions, that the trial examiner's report shall be advisory only and that his findings of fact shall not be binding upon the Commission. Their purpose is primarily to narrow the issues. "The Commission, however, makes its own findings, as it is duty bound."[9] And if the examiner's finding is not established by "the

[5]Section 8 (d) of the Act provides: "If it appears to the Commission at any time that the registration statement includes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading, the Commission may, after notice by personal service or the sending of confirmed telegraphic notice, and after opportunity for hearing (at a time fixed by the Commission) within fifteen days after such notice by personal service or the sending of such telegraphic notice, issue a stop order suspending the effectiveness of the registration statement. When such statement has been amended in accordance with such stop order the Commission shall so declare and thereupon the stop order shall cease to be effective."

Reflection in a prospectus of defects in the registration statement serves as a further ground for the rejection of a proposed issue. Matter of Consolidated Mines Syndicate, Securities Act Release No. 1448, May 20, 1937. Sales literature is not *per se* properly subject to the issuance of a stop order, unless it is filed as part of the registration statement, for Section 8(d) is restricted to deficiencies in the registration statement. (Such literature, however, is subject to Section 17 of the Act. See note 21, *infra*.) But where the sales literature seriously misrepresents the facts, it increases the materiality of any parallel deficiencies in the prospectus by predisposing the reader to accept the statements of the prospectus in an interpretation consistent with the sales literature. Matter of Registration Statement of Income Estates of America, Inc., Securities Act Release No. 1480, June 29, 1937.

[6]Rule 945 of the General Rules and Regulations under the Securities Act.

[7]Jones v. SEC, 79 F. (2d) 617 (C. C. A. 2d, 1935). The Commission may appear in court by its own solicitor and is not required to appear by the Attorney-General or by a district attorney. SEC v. Robert Collier & Co., 76 F. (2d) 939 (C. C. A. 2d, 1935), *cert. denied sub nom.* Stock Market Finance, Inc., v. SEC, 297 U. S. 713, 80 L. ed. 999 (1936).

[8]SEC, Rules of Practice (Nov. 4, 1936) VIII(c). "The initial page of the report shall contain a statement to such effect." Rule X provides for the filing of briefs on exceptions to the trial examiner's report. Rule XI deals with hearings on review before the Commission.

[9]Matter of Meehan, Exchange Act Release No. 1331, Aug. 2, 1937, p. 38 [citing Morgan v. United States, 298 U. S. 468, 80 L. ed. 1288 (1936)]; Matter of Mutual Industrial Bankers, 1 SEC 268 (1936) ("We cannot concur in the

fair balance of the evidence," registrant's exceptions will be sustained.[10]

Rule of Practice V(b) provides that motions in any proceeding before a trial examiner which relate to the introduction or striking of evidence may be ruled on by the trial examiner. All other motions must be reserved and ruled upon by the Commission itself. It is therefore beyond the jurisdiction of the trial examiner to act on registrant's motion for dismissal of the hearing on the ground that registrant is willing to change the representations in its prospectus.[11] And a finding that in the examiner's judgment a registrant has committed a crime as well as given cause for the issuance of a stop order has no place in the examiner's report.[12]

The Commission has frequently pointed out that it is not within its province to determine the prospective success or failure of registrant's proposed enterprise.[13] A complete and truthful disclosure of pertinent facts, therefore, debars the issuance of a stop order.[14] No matter how speculative or foolhardy a venture may be, the Commission has no power to prevent the public offering of registrant's security if the full truth is told.[15]

A condition precedent to the issuance of a stop order is the existence of deficiencies relating to statements or omissions of ma-

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findings of the trial examiner"); Matter of Mineral Products, Inc., 1 SEC 479 (1936). But rather than needlessly repeat many patent deficiencies in the registration statement, the Commission may adopt the findings of fact set forth in detail in the trial examiner's report. Matter of Herman Hanson Oil Syndicate, Securities Act Release No. 1555, Sept. 15, 1937.

[10]Matter of Brandy-Wine Brewing Co., 1 SEC 123, 138 (1935).

[11]Matter of American Credit Corp., 1 SEC 230 (1935). *Cf.* Matter of Metropolitan Personal Loan Co., Securities Act Release No. 1594, Oct. 28, 1937.

[12]Matter of Howard, 1 SEC 6, 11, footnote (1934).

[13]Compare the statement of the President in his message to Congress of March 29, 1933: "Of course, the Federal Government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties they represent will earn profit." H. R. REP. No. 85, 73d Cong., 1st Sess. (1933) 1.

[14]Matter of Callahan Zinc-Lead Co., 1 SEC 115 (1935); Matter of Plymouth Consolidated Gold Mines, Ltd., 1 SEC 139 (1935).

[15]Matter of National Educators Mutual Ass'n, Inc., 1 SEC 208 (1935). See *Hearings on H. R. 4314*, 73d Cong., 1st Sess. (1933) 58, Pt. 16. It seems highly dubious that the lack of power to prevent security issues is a serious handicap to the performance of the Commission's job. Front page publicity given to the less estimable features of a particular offering seems an adequate substitute for the authority to give a flat refusal. For an especially dramatic demonstration of this, see Securities Act Release No. 1294, March 2, 1937. Moreover there seems to be a decided advantage to the Commission in being spared the sort of censure that plagues a banking or insurance commissioner who even without fault permits an unhealthy institution to carry on its tragic downhill trip a luckless public load.

teral facts,[16] but when the respondent does not raise an issue of materiality, the Commission need consider only the existence of deficiencies as such, without an inquiry into their materiality. If deficiencies are established a stop order may issue.[17]

The accuracy of information contained in the registration statement is tested as of its date of effectiveness.[18] When transactions subsequent to the filing of the registration statement are not reflected therein by amendment so that the unaltered statements are no longer true, they may serve as the basis for the issuance of a stop order.[19] The jurisdiction of the Commission to issue a stop order is by no means dependent upon the continuance of distribution but may be exercised at any time. The registration statement is regarded as remaining "effective" after original distribution has been completed, since it is a continuing representation of material facts existing as of the effective date. Information contained in a registration statement, without limitation as to time, is available to the public. Hence the Commission will require cor-

[16]Matter of Howard, 1 SEC 6 (1934). Deficiencies not relating to material facts do not give ground for the issuance of a stop order, but may "be included in a notice to show cause" why a stop order should not be issued. *Id.* at 8. And when a stop order is issued on proper grounds, it may embrace in its terms other deficiencies which have been included in the notice to show cause. Matter of Commonwealth Bond Corp., 1 SEC 13 (1934). The Commission considers it inappropriate to consider in a stop order proceeding deficiencies not alleged in the notice of hearing and specifications of matters to be considered. Matter of Paper Sales Co. of Detroit, Inc., Securities Act Release No. 1556, Sept. 16, 1937. Where items were not included in the notice of hearing and specifications of matters to be considered, the Commission has disaffirmed findings on such items by the trial examiner. Matter of Metropolitan Personal Loan Co., Securities Act Release No. 1594, Oct. 28, 1937.

[17]Matter of Howard, 1 SEC 6 (1934); Matter of Big Wedge Gold Mining Co., 1 SEC 98 (1935); Matter of Texas-Oklahoma Trust, Securities Act Release No. 1563, Sept. 23, 1937.

[18]Matter of Snow Point Mining Co., Inc., 1 SEC 311 (1936) (modification of contracts filed with registration statement).

[19]*Cf.* Matter of Mineral Products, Inc., 1 SEC 479 (1936). Registrant has a further duty of disclosure, arising from the fact that its statements are tested as of their effective date. So, if a statement is true when made, but registrant learns prior to the date when the registration becomes effective that the statement is false, a duty of correcting it rests upon registrant, if it would avoid liability under Section 11. And if after the effective date statements become untrue, *vendors* of registrant's securities who know or ought to know this, must disclose the fact to their customers to avoid liability under Section 12(2). See Matter of Howard, 1 SEC 6 (1934) (institution of legal proceedings affecting securities to be called for deposit). "The actual experience of administering the statute has shown that . . . [stop] orders have been a stronger weapon . . . than the *in terrorem* aspect of the civil liability provisions." MacChesney, *The Securities Act and the Promoter* (1936) 25 CALIF. L. REV. 66, 78-9. For general discussions of this subject, see Shulman, *Civil Liability & the Securities Act* (1933) 43 YALE L. J. 227; Legis. (1934) 48 HARV. L. REV. 107; Comment (1935) 44 YALE L. J. 456. For an application of Section 11(c) on what constitutes reasonable reliance by an issuer's directors upon the accuracy of reports by experts in the preparation of a registration statement, see Martin v. Hull and Butler (D. C. D. C., June 1, 1937).

rection of a false registration statement in order to protect post-distribution investors.[20] But if after the registration statement becomes effective, the information becomes untrue, the Commission may not issue a stop order, since the registration statement was accurate on the effective date.[21]

The truth or falsity of statements is in issue in stop order proceedings regardless of the good faith of the respondents, except as

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[20]Matter of Oklahoma-Texas Trust, Securities Act Release No. 1563, Sept. 23, 1937. Under Section 11, any purchaser of a registered security as to which registrant's statement is false is afforded a civil remedy for damages regardless of whether the purchase was made during the course of original distribution. *Cf.* note 19, *supra.*

"Protection of investors" includes not only warning the public who have not yet purchased registrant's securities against buying and those who have purchased against further investment. It involves a publication of registrant's false statements so that subscribers may be warned against completing their payments and in order that purchasers may take advantage of their fraud or rescission rights under Section 11. Matter of National Boston Montana Mines Corp., 1 SEC 639 (1936). Publication is particularly important when the securities are already issued and circulating on the exchanges and over-the-counter markets. Matter of Bankers Union Life Co., Securities Act Release No. 1278, Feb. 23, 1937. Under such conditions, withdrawal of the registration statement is not the substantial equivalent of a stop order. Matter of National Boston Montana Mines Corp., *supra.* The Commission has provided in Rule 960 of its General Rules & Regulations under the Securities Act, that a registration statement may be withdrawn if the Commission consents, but that the papers comprising the registration statement may not be removed from the files of the Commission. On the problem of withdrawal, see discussion of Jones v. SEC, *infra,* p. 16.

[21]See Matter of Howard, 1 SEC 6, 10 (1934). The Commission may then institute a suit for an injunction, pursuant to Section 17(a). Thus a stock jobber who paid dividends out of his own pocket to induce prospective purchasers to believe that the corporation whose shares he was selling was operating at a profit has been permanently enjoined against fraudulent sales in violation of Section 17(a) of the Securities Act. SEC v. Krystal, 2 PRENTICE-HALL SECURITIES REGULATION SERV., par. 7147 (D. C. D. C. 1937). Where a broker had bought stock on the vendor's agreement to withhold from the market the balance of his shares while the broker disposed of its holding at a profit, an injunction was granted under Section 17(a)(2) because no disclosure to customers had been made of the withholding agreement. Artificial restrictions in supply and stimulations of demand must be disclosed. SEC v. Otis & Co., 18 F. Supp. 100 (N. D. Ohio 1936); *Cf.* Coplin v. United States, 88 F. (2d) 652, 661 (C. C. A. 9th, 1937), *cert. denied,* May 24, 1937. The Commission may obtain an injunction *pendente lite* where the respondent has apparently ceased the sale of securities just prior to the filing by the Commission of a bill to restrain, provided it appears to the court that respondent may resume the acts complained of. Apparent discontinuance of sales does not warrant dismissal of the Commission's bill. SEC v. Hertz & Co., 2 PRENTICE-HALL SECURITIES REGULATION SERV., par. 7148 (D. C. D. C. 1937). But where respondent was no longer engaging in the forbidden practices, and there was no ground to infer that he would repeat the violations in the future, a preliminary injunction was held improper. SEC v. Torr, 87 F. (2d) 446 (C. C. A. 2d, 1937). A further factor entering into the decision may have been the finding of the majority (L. Hand, J., dissenting) that respondent in good faith thought it was not in violation of the statute. *Cf.* SEC v. Saphier, 2 PRENTICE-HALL SECURITIES REGULATION SERV., par. 12305 (D. C. S. D. 1936).

to information which is expressly called for only "if known."[22] Thus a stop order will issue because of defects arising from incompetence, even though registrant is honest and has prepared a registration statement to the best of its ability,[23] and the question whether misrepresentations are deliberate does not have to be determined in a stop order proceeding.[24] The mere negligence of registrant in permitting its statement to become effective in spite of material deficiencies which it knew to exist, and the fact that registrant sold stock on the basis of such defects has been held too serious to warrant a dismissal of stop order proceeding.[25] And it is ordinarily a matter of no concern to the Commission whether directors of registrant could escape civil liability by showing themselves to have been in the exercise of due care in relying on the misstatements of an expert.[26]

The issuance of a stop order is discretionary.[27] The Commission may consider the situation as of the time of the issuance of the order, and not limit itself to the circumstances as of the notice of initiation of the proceeding. Thus, if amendments cure defects in the registration statement, the Commission may refrain from issuing a stop order.[28] Where registrant came forward with amendments in an effort promptly to correct cited deficiencies, the Commission considered the amendments, and as they appeared not to be

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[22]Matter of Unity Gold Corp., 1 SEC 25 (1934). The wisdom of the qualification to the above stated principle is open to serious doubt. The Commission has apparently confused the basis of a stop order under Section 8(d) with the essentials of civil liability under Section 11. It would seem that a stop order should issue because of defects discovered by the Commission even as to information unknown in good faith to those preparing a registration statement. A stop order lacks the impact against the person of an individual which is the crucial feature of civil (or criminal) liability. The primary purpose of the stop order is simply to prevent the sale of the securities for which registration is being sought.

[23]Matter of Herman Hanson Oil Syndicate, Securities Act Release No. 1555, Sept. 15, 1937. "The Securities Act of 1933 requires more than good faith; it requires, as well, that those who seek trusteeship of the public's money on the basis of information in the registration statement and the prospectus, must live up to certain minimum standards of ability and due care in their preparation."

[24]Matter of Sunset Gold Fields, Inc., Securities Act Release No. 1452, May 20, 1937. *Cf.* Emporia Gold Mines, Inc., Securities Act Release No. 1401, April 23, 1937.

[25]Matter of Condor Pictures, Inc., Securities Act Release No. 1433, May 11, 1937.

[26]Matter of Haddam Distillers Corp., 1 SEC 37 (1934). *Cf.* Martin v. Hull, (D. C. D. C., June 1, 1937) cited note 19, *supra.*

[27]Section 8(d) reads: "the Commission *may* . . . issue a stop order . . ." (Italics supplied). *Cf.* Matter of Cornucopia Gold Mines, 1 SEC 364 (1936).

[28]Matter of Haddam Distillers Corp., 1 SEC 37 (1934); Matter of Cornucopia Gold Mines, 1 SEC 364 (1936); Matter of Condor Pictures, Inc., Securities Act Release No. 1433, May 11, 1937.

incomplete or inaccurate declared them effective[29] and dismissed the proceedings even though ample grounds existed for the issuance of a stop order.[30] But when registrant has been guilty of a disregard of fundamental business ethics, the Commission has refused to exercise its discretion to refrain from issuing a stop order simply because registrant has submitted corrective amendments.[31] Registrant must wait for the expiration of the twenty-day period which begins running anew with the filing of each amendment, unless the Commission "consents" to the filing.[32] Even where registrant admits the deficiencies in its statement and stipulates that no sales of its securities had been or would be made until the registration statement was corrected, the Commission may nevertheless suspend its effectiveness until amendments have been filed which correct the deficiencies.[33] And the Commission will discontinue the taking of further testimony only after registrant admits the allegations in the stop order notice, thereby enabling the Commission to suspend the registration statement.[34]

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[29]Such action is taken pursuant to Section 8(c) which provides: "An amendment filed after the effective date of the registration statement, if such amendment, upon its face, appears to the Commission not to be incomplete or inaccurate in any material respect, shall become effective on such date as the Commission may determine, having due regard to the public interest and the protection of investors."

[30]Matter of Registration Statement of Bainbridge Colby, *etc.*, Securities Act Release No. 1488, June 28, 1937; Matter of Equity Corp., Securities Act Release No. 1535, Aug. 24, 1937; Matter of Consolidated Funds Corp., Securities Act Release No. 1548, Sept. 9, 1937. The fact that registrant states it will send copies of the amendments to all its present shareholders that they may be apprised of the information set forth therein, and the further fact that considerable time has elapsed since registrant has sold any of the registered securities seem to influence the Commission to allow amendments to become effective, instead of subjecting registrant to the usual twenty-day delay.

[31]Matter of Haddam Distillers Corp., 1 SEC 37 (1934) (an appraisal of its property based on a patently unconscionable pretense of scientific method); see Matter of Continental Distillers & Importers Corp., 1 SEC 54, 57 (1935).

[32]Matter of Callahan Zinc-Lead Co., 1 SEC 115 (1935). See Section 8(a). Registrant may suffer in two ways: first, by the postponement of the date of effectiveness of the registration statement, and second, because the registration statement is deemed to have been *filed* when the amendment was filed. See Matter of Mutual Industrial Bankers, Inc., 1 SEC 268 (1936); Matter of Registration Statement of Income Estates of America, Inc., Securities Act Release No. 1480, June 29, 1937; and Matter of Old Diamond Gold Mines, Ltd., Securities Act Release No. 1576, Oct. 8, 1937, where pre-effective amendments caused a balance sheet to be no longer as of ninety days of the *filing date* and thereby rendered the registration statement defective.

[33]Matter of Santa Lucia Mining Co., 1 SEC 293 (1936); Matter of Newman Dick Mining & Development Co., 1 SEC 447 (1936). The Commission has, in its discretion, consented to a registrant's request for the dismissal of stop order proceedings [Section 8(d)] and granted a refusal order [Section 8(b)] since the latter effectively prevents any offering until it is lifted by the Commission. Matter of International Investors Fund System, Inc., 1 SEC 461 (1936).

[34]Matter of Strong Leasing & Mining Co., 1 SEC 121 (1935). Registrant further stipulated in the record that no stock would be offered for sale pending the issuance of the stop order.

Though the Commission might issue a stop order without comment on the facts as they appear from the record, it will, when the public interest requires, call attention to certain of registrant's omissions and misstatements.[35] The Commission has often transmitted "to the public generally, evidence of registrant's disregard of important legal and ethical standards," despite registrant's consent to the issuance of a stop order at the opening of the hearing.[36] Of course, where the statements under attack were more seriously misleading than admitted, the Commission considered it in the public interest that it publish its findings.[37] Nor has a registrant succeeded in forestalling publication of the facts of its case through waiving its right to file a brief and be heard by the Commission.[38] Indeed the tenor of language in the more recent decisions seems to indicate that the Commission is coming to regard full publication as mandatory—at least in some cases.[39]

Notwithstanding the declaration of Section 8(a) that the effective date of a registration statement shall be the twentieth day after its filing, the Supreme Court held, in *Jones v. SEC*[40] that the intervention of a stop order proceeding prevents effectiveness pending the hearing and decision. On this basis a divided court ruled that a registrant has an unqualified right, not subject to administrative discretion, to withdraw its statement where no investors would be adversely affected. It was further held that since the

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[35]Matter of American Gyro Co., 1 SEC 83 (1935).

[36]Matter of Big Wedge Gold Mining Co., 1 SEC 98 (1935). Naturally, consent given during or after the hearing is of no more avail to registrant. Matter of National Educators Mutual Ass'n, Inc., 1 SEC 208 (1935); Matter of Oil Ridge Oil & Refining Co., 1 SEC 225 (1935); Matter of Continental Distillers & Importers Corp., 1 SEC 54 (1935); Matter of La Luz Mining Corp., 1 SEC 217 (1935).

[37]Matter of Registration Statement of Income Estates of America, Inc., Securities Act Release No. 1480, June 29, 1937.

[38]Matter of Continental Distillers & Importers Corp., 1 SEC 54 (1935).

[39]Compare Matter of Haddam Distillers Corp., 1 SEC 37, 47, 57 (1934) with Matter of American Credit Corp., 1 SEC 230, 232 (1935) and Matter of Avocalon Extension Syndicate, Ltd., 1 SEC 657 (1936). In Matter of Sunset Gold Fields, Inc., Securities Act Release No. 1452, May 20, 1937, it was said, "The fact that registrant proposes to discontinue the attempt to dispose of the remainder of this offering cannot be thought to provide it with any immunity from such exposure as it is the Commission's *duty* to make." *Id.* at 2. (Italics supplied).

It may well be argued that a duty should be imposed on the Commission by statute to render and make public detailed opinions in all cases where stop orders, or other orders of equal seriousness, issue. Publicity is probably the Commission's most potent weapon and should be used to its full effectiveness. Indeed, attention might be given to the problem of extending the penetration point of Commission releases beyond the immediate financial community to the great body of laymen investors, especially that group which has already participated in, or been approached with respect to, the particular issue being restrained.

[40]298 U. S. 1, 80 L. ed. 1015 (1936), Brandeis, Stone, and Cardozo, JJ., dissenting; (1936) 49 HARV. L. REV. 1369.

stop order proceeding was the only disclosed purpose for which an investigation of registrant's affairs was being undertaken, and since the investigation ceased to be legitimate upon registrant's withdrawal of its statement, the Commission could not predicate a right to proceed with the inquiry on its general power to conduct investigations.[41]

In holding that the registrant had an absolute right to withdraw before its statement became effective, the Supreme Court ignored the adversary nature of the stop order proceeding, and regarding registrant's statement as an application for the right to issue its securities, compared it to an *ex parte* proceeding which might be dropped at any time. But in *Matter of National Boston*

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[41]See Jones v. SEC, 298 U. S. 1, 25, 80 L. ed. 1015, 1025 (1936). But it would seem that the Commission is authorized to subpoena a registrant, as against the contention that the issuance of a stop order is the only sanction available to compel attendance at its hearings. Jones v. SEC, 79 F. (2d) 617 (C. C. A. 2d, 1935).

Section 19(b) of the Securities Act and Section 21 of the Exchange Act authorize the Commission to make investigations as to violations of these statutes and empower it to subpoena witnesses. See Comment (1935) 44 YALE L. J. 819; Colclough, *The Securities and Exchange Commission's Power of Search* (1935) 3 GEO. WASH. L. REV. 356. *Cf.* I. C. C. v. Brimson, 154 U. S. 447, 38 L. ed. 1047 (1893) where the court upheld Section 12 of the Interstate Commerce Act authorizing the compulsion of witnesses to attend investigations on the enforcement of that act. A district court has declared itself not without jurisdiction to require a registrant to submit to examination before the Commission because a proceeding was pending in a circuit court of appeals to review the Commission's order requiring his attendance, when the circuit court had not issued a stay. SEC v. Jones, 12 F. Supp. 210 (S. D. N. Y. 1935). A person cannot enjoin his broker from complying with the Commission's subpoena to produce a statement of his brokerage account, where the investigation was properly limited in scope. McMann v. SEC, 87 F. (2d) 377 (C. C. A. 2d, 1937), *affirming* McMann v. Engel, 16 F. Supp. 446 (S. D. N. Y. 1936) where the Commission limited its investigation to the transactions of the customer in only two stocks, as to which the Commission already had some evidence of violations of the Securities Act. The documents demanded were few and their production did not interfere with the business of the broker. The customer has no privilege to keep secret the brokerage records of his speculations in the stock market. If the investigation is duly authorized it is no more subject to obstruction than judicial proceedings. Because of alleged indefiniteness of the Commission's subpoenas, the familiar cry of "fishing expedition" has been raised, and one court has answered the objector that "It will be ample time for him to kick when he is spurred." SEC v. Jones, 12 F. Supp. 210, 215 (S. D. N. Y. 1935). A less figurative explanation for judicial antipathy to this complaint has been that if the subpoena or order were required to set out more definite facts, it would make investigations available only when superfluous. And the fact that the Commission may abuse its authority to publish information revealed in its investigations is not a sufficent reason to forbid or restrain them. *In re* SEC, 84 F. (2d) 316 (C. C. A. 2d, 1936) (employees of firm under investigation could be compelled to testify without transcripts of their testimony). There is no invasion of a person's constitutional rights under the fourth and fifth amendments when messages which he wired are subpoenaed in the course of a lawful investigation conducted by the Commission, from the telegraph company which transmitted them. Newfield v. Ryan, 91 F. (2d) 700 (C. C. A. 5th, 1937), *cert. denied*, Oct. 18, 1937, *petition for rehearing denied*, Nov. 8, 1937.

Montana Mines Corp.[42] the request to withdraw a registration statement was subsequent to its becoming effective and the Commission held that consent to such withdrawal was a matter for its discretion, subject to a finding that such action would be consistent with the public interest and for the protection of investors. The Commission reasoned that a registrant who had sold securities under an effective statement and against whom the Commission was now the moving party might not terminate the proceedings commenced against it, and thus avoid a decision on the merits.

The doctrine of the *National Boston Montana Mines* case has been extended in *Matter of Paper Sales Co. of Detroit, Inc.*[43] It was there held that unless the application to withdraw was supported by a showing that no public offering or sale of the securities registered had been or was intended to be made, withdrawal would be refused. Even though testimony was offered at the hearing that no securities had been offered for sale, the Commission declined to assume that no sales had been made subsequent to the hearing and prior to the filing of the request to withdraw.

Upon entry of a stop order,[44] or the suspension of a registration statement pending a stop order proceeding,[45] Section 5 forbids the use of the mails and channels of interstate commerce in the distribution of and dealing in the security. The primary purpose of a stop order is to prevent the sale of securities upon the basis of false or misleading information. Although its issuance may be regarded as having certain punitive aspects insofar as it may obstruct or delay the offering, or may hold up registrant's misconduct to public

[42]1 SEC 639 (1936). *Cf.* Matter of Strong Leasing and Mining Co., 1 SEC 121 (1935).

[43]Securities Act Release No. 1556, Sept. 16, 1937. Indeed the implication of these two cases seems to be that the Commission will in all probability hold that a registrant has no unqualified right of withdrawal, even though its registration statement is not yet effective, unless there is a positive showing by registrant that no securities have been sold or offered for sale. Apparently, Jones v. SEC will be so stringently limited to its facts as to lose significance. As a practical matter, the Commission may, by refraining from instituting stop order proceedings until the day on which the registration statement becomes effective, avoid altogether the rule of the Jones case as interpreted by the Commission. In this connection it is interesting to note that the stop order proceeding against Jones was begun on the nineteenth day after the registration statement was filed.

[44]Matter of National Boston Montana Mines Corp., 1 SEC 639 (1936). See Section 5.

[45]Jones v. SEC, 298 U. S. 1, 80 L. ed. 1015 (1936). The court was of the opinion that the word "effective" within the meaning of Section 5(a) connoted completeness of operative force and freedom to act. Since registrant did not enjoy complete freedom of action because of the stop order proceeding, the court reasoned that the registration statement was not "effective," and therefore registrant would act at his peril if he distributed his securities. It would seem that this reasoning begs the question.

condemnation, it is a preventive rather than a punitive measure.[46] Consequently, it is mandatory upon the Commission under Section 8(d) to declare a stop order inoperative when, in its opinion, the deficiencies have been cured by amendment.[47] But a stop order will not be lifted without complete assurance that the registration statement and the prospectus have been made "free from misrepresentation and ingenuous misstatement."[48] And mere amendment in accordance with the order will not in itself assure effectiveness of the registration statement, because the amendments may raise questions of new deficiencies not originally alleged.[49]

Definitions

Section 2(1)[50] defines "security" very broadly to prevent evasion, and in cases litigated under the Act the courts have given effect to this purpose. Thus in *SEC v. Wickham*[51] where respondent offered interests in a trading pool, the contract purporting to create an agency to invest and manage funds and securities of the "principal," the court held that the phrase "certificate of interest or participation in any profit-sharing agreement" was amply inclusive to embrace the contract. In determining whether the transaction involved the issuance of a security, the court said substance, and not form, would control. The contention that forged bonds

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[46]Matter of Haddam Distillers Corp., 1 SEC 48 (1934). "Actual punishment of a registrant must be predicated upon a violation of Section 24 of the Securities Act, and violations of that section are the subject of judicial and not administrative condemnation, and their prosecution is entrusted to another agency of the government." *Id.* at 49.

[47]Matter of Haddam Distillers Corp., 1 SEC 48 (1934). But, conversely, the Commission's examination under Section 8(c) does not estop it from subsequent action at any time under 8(d). Matter of Bankers Union Life Co., Securities Act Release No. 1278, Feb. 23, 1937.

[48]Matter of National Educators Mutual Ass'n, 1 SEC 208, 214 (1935).

[49]Matter of Haddam Distillers Corp., 1 SEC 48 (1934). *Cf.* Matter of Mutual Industrial Bankers, Inc., 1 SEC 268 (1936). In view of the mandatory nature of the language of Section 8(d) that "when such statement has been amended in accordance with such stop order the Commission *shall* so declare and thereupon the stop order *shall* cease to be effective," and in view of the requirements of notice and hearing under this section when a deficiency is challenged by the Commission, it would seem that this assumption of power by the Commission may be open to question. (Italics supplied). A strict adherence to the letter of the statute might require the same formality of notice and hearing as in the original proceeding.

[50]"The term 'security' means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, pre-organization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a 'security,' or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing."

[51]12 F. Supp. 245 (D. Minn. 1935); (1935) 36 COL. L. REV. 683; (1935) 4 GEO. WASH. L. REV. 156.

are not securities has been held to be wholly untenable.[52] Promissory notes are covered by the definition which expressly names any "note" or "evidence of indebtedness."[53] In *SEC v. United Prosperity Plan, Inc.*[54] certificates were used as money among members of movements sponsored by the defendant corporation. Special stamps were sold by the corporation which had to be affixed to the certificates before they could be used. These stamps had the effect, under the plan, of bringing new funds to the defendant, which were to be returned to members in the form of new "Prosperity Certificates." The court held that these were securities as defined by Section 2(1). The argument that participation trust certificates in producing oil royalties are not securities has not prevailed.[55] In *SEC v. Crude Oil Corp.*[56] a bill of sale and contract for the delivery of oil by a corporation purchasing oil royalties is also within the definition of the Act. On the other hand the Chief of the Securities Division of the Federal Trade Commission expressed the opinion that a contract for the delayed delivery of securities was not itself a security, but rather a contract to buy or sell a security upon a contingency.[57]

Section 2(3)[58] continues the policy of broad definition, so that the Commission's jurisdiction does not depend on a "sale" of securi-

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[52]Seeman v. United States, 90 F. (2d) 88 (C. C. A. 5th, 1937).

[53]Matter of Friedlander, *etc.*, Exchange Act Release No. 1305, July 16, 1937.

[54]D. C. Utah, Oct. 9, 1937.

[55]SEC v. Jones, 12 F. Supp. 210 (S. D. N. Y. 1935).

[56]17 F. Supp. 164 (W. D. Wis. 1936). This case is now pending on appeal to the Circuit Court of Appeals for the Seventh Circuit. *Cf.* SEC v. Aldrich Blake, Inc. (D. C. D. C. May 19, 1936) 133 C. C. H., par. 8542.

[57]Letter of Baldwin B. Bane to Wm. A. Lockwood, June 8, 1934, 1 PRENTICE-HALL, FEDERAL SECURITIES SERV., par. 7003. Informal opinions expressed in letters or releases by the General Counsel's Office of the SEC represent the views of the writer and are not to be taken as expressions of the opinions of the Commission. Since the opinions of the General Counsel are purely gratuitous, it would seem that one who relies upon them might not be within the protection of the exculpatory clause of Section 19(a): "No provision of this title imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule or regulation of the Commission, notwithstanding that such rule or regulation may, after such act or omission, be amended or rescinded or be determined by judicial or other authority to be invalid for any reason."

[58]"The term 'sale', 'sell', 'offer to sell', or 'offer for sale' shall include every contract of sale or disposition of, attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value; except that such terms shall not include preliminary negotiations or agreements between an issuer and any underwriter. Any security given or delivered with, or as a bonus on account of, any purchase of securities or any other thing, shall be conclusively presumed to constitute a part of the subject of such purchase and to have been sold for value. The issue or transfer of a right or privilege, when originally issued or transferred with a security, giving the holder of such security the right to convert such security into another security of the same issuer or of another person, or giving a right to subscribe to another security of the same issuer or of another person, which right cannot be exercised

ties in the usual common law sense. The distribution of stock free of charge, but subject to assessment, the stockholder being under no obligation to pay, but forfeiting his interest by failure to meet assessments, is an "attempt to dispose of" the securities and therefore a "sale" within the meaning of the Act.[59] The distribution of certificates in the usual business trust gives rise to a sale and not to a contract of agency between the certificate holder and the company.[60] The solicitation of brokerage orders for the purchase of securities constitutes a sale because the "solicitation of an offer to buy" is expressly included in Section 2(3).[61] If a corporation declares a dividend payable either in cash or in securities at the election of shareholders, neither the declaration of the dividend nor the distribution of the stock constitutes a sale. But if the corporation should declare a cash dividend and thereafter offer securities to shareholders in lieu of the cash to which they would be entitled under the previous declaration, the offering would involve a sale.[62] Underwriters who wish to inform a selling group of the nature of a security that will be offered after the effective date of the registration statement may circulate full information by indicating clearly in their communication that no offers to buy should be sent, or would be accepted, until the effective date.[63] This opinion has been extended to permit summaries of a registration statement to be circulated by both underwriters and dealers among the investing public generally. But the condition is strictly annexed that such a circular must not constitute or be used in connection with an offer to sell or the solicitation of an offer to buy the securities described.[64]

The fact that a contract of sale may have been illegal and unenforceable because of state law is immaterial since Section 2(3) includes an "attempt to sell."[65] The broad definition applies

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until some future date, shall not be deemed to be a sale of such other security; but the issue or transfer of such other security upon the exercise of such right of conversion or subscription shall be deemed a sale of such other security." See generally Securities Act Release No. 97, Dec. 28, 1933.

[59] *Cf.* Matter of Gold Producers, Inc., 1 SEC 1 (1933). No exemption under Rules 200, 201, and 202 (dealing with issues of $100,000 or less) is available for issues of assessable stock unless the total amount of assessment which may be levied is limited so that the aggregate offering price does not exceed $100,000. *Cf.* Securities Act Release No. 1587, Oct. 20, 1937.

[60] Matter of Wee Investors Royalty Co., 1 SEC 202 (1935).

[61] Securities Act Release No. 1256, Feb. 9, 1937. It should be noted also that the "solicitation" of customer's orders is expressly excluded from the transactions exempted by Section 4(2), *i.e.*, "Broker's transactions, executed upon customers' orders . . ."

[62] Securities Act Release No. 929, July 29, 1936. On problems raised by consolidation and merger, see Securities Act Release No. 493, Sept. 20, 1935.

[63] Securities Act Release No. 70, Nov. 6, 1933.

[64] Securities Act Release No. 802, May 24, 1936.

[65] Matter of Gold Producers, Inc., 1 SEC 1 (1933).

throughout the Act so that an attempt to narrow the meaning of sale as used in Section 17, dealing with fraud, is unavailing.[66]

Section 2(11)[67] defines "underwriter" also comprehensively and the Commission has, in further elaboration, ruled that a person whose business is chiefly the purchasing of securities of an issuer, and in the sale of his own securities to furnish the proceeds with which to acquire the securities of such issuer, is engaged in their "distribution" within Section 2(11).[68] A reorganization committee, acting as such, is not regarded as an "underwriter" for the securities which are called for deposit.[69] A person whose interest in an issue is limited to the usual distributors' and sellers' commission is not an underwriter. The Regulations provide that a commission includes the spread received by a dealer as a consequence of reselling securities bought from an underwriter at a price below the offering price, where the profit is not in excess of what is usual in such transactions. The "usual" spread is determined by the type and size of the issue, the amount paid to others in similar issues, and the amount allowed others for comparable services in the distribution of the particular issue.[70] In adopting the findings of the trial examiner in *Matter of American Gyro Co.*[71] it would seem that the Commission considers salesmen engaged by registrant to sell its issue upon a twenty-five percent commission basis to be underwriters. Under no circumstances does "commission" include payments made to those who manage the distribution of all or a substantial part of the particular issue.[72]

Although the term "promoter" has never been judicially defined with respect to the Securities Act, it has generally been construed to apply to a person who enters into a common enterprise with other persons to form a corporation, transfer property to it and sell stock to the public. The Commission holds the term to be broad enough to include one who, in concert with the actual incorporators, purchases property with the intent to sell it to an enterprise yet to be formed, and to receive his compensation from

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[66]United States v. Bogy, 16 F. Supp. 407 (W. D. Tenn. 1936).

[67]"The term 'underwriter' means any person who has purchased from an issuer with a view to, or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission. As used in this paragraph the term 'issuer' shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer."

[68]General Rules & Regulations under the Securities Act, Rule 140.

[69]Matter of Commonwealth Bond Corp., 1 SEC 13 (1934).

[70]General Rules & Regulations under the Securities Act, Rule 141.

[71]1 SEC 82, 93 (1935).

[72]General Rules & Regulations under the Securities Act, Rule 141.

the purchase price of securities to be distributed to the public.[73] But less than actual ownership of the property to be sold to the corporation may suffice. Thus one who merely conducted some of the preliminary negotiations with owners of property later acquired by registrant was held to be a promoter and should have been named in the registration statement.[74] And one who received a "commission" for "negotiating" the sale of property to registrant's controlling stockholder, and who was the latter's law partner, should have been named as a promoter when the property was contemporaneously conveyed to the corporation.[75] But the fact that one is assigned a portion of a promoter's profits does not make him a promoter, although the fact that the assignment was made without consideration might make it appear that the promoter was acting as an agent for the assignee. Inferences drawn from a refusal to answer pertinent questions are not sufficient to cause the Commission to find a person to be a promoter.[76]

One who is instrumental in organizing, through public subscriptions, a corporation which is to take over the assets of a predecessor corporation must be classed as a promoter, when the new corporation is formed to develop a project which had never been successfully operated by the original corporation. Such a reorganization is a promotional venture.[77]

One term of vast importance to federal securities regulation and practically impossible of succinct definition is "material fact." Although the Act is silent as to the meaning of "materiality," the Commission itself has dealt with the problem. It has ruled that when the term is used to qualify a requirement for information, it limits details to those matters as to which an average prudent investor ought reasonably to be informed before buying the security registered.[78] A material fact, the Commission has elsewhere defined, following English authority,[79] is one "which, if it had been correctly stated or disclosed, would have deterred or tended to deter the average prudent investor from purchasing."[80]

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[73]Matter of Texas-Oklahoma Trust, Securities Act Release No. 1563, Sept. 23, 1937.

[74]Matter of Snow Point Mining Co., Inc., 1 SEC 311 (1936).

[75]Matter of Continental Distillers & Importers Corp., 1 SEC 54 (1935).

[76]Matter of Texas-Oklahoma Trust, Securities Act Release No. 1563, Sept. 23, 1937.

[77]Matter of National Boston Montana Mines Corp., Securities Act Release No. 1409, April 30, 1937.

[78]General Rules & Regulations under the Securities Act, Rule 455.

[79]Broome v. Speak [1903] 1 Ch. 586, 604, *aff'd in* [1904] A. C. 342; Smith v. Chadwick, 9 App. Cas. 187.

[80]Matter of Howard, 1 SEC 6, 8 (1934). See Dodd, *Amending the Securities Act* (1935) 45 YALE L. J. 199, 219. It is obvious that these two definitions of "materiality" are substantially different. For example, a fact which might *not* deter a prospective investor from purchasing the security

As a practical matter the Commission has not bound itself to specific misstatements of material facts. When the issue of materiality is raised, the cumulative effect of all deficiencies is considered, and where a registration statement does not adequately reflect information necessary for an intelligent understanding of registrant's affairs, the Commission will brand it materially defective.[81]

Misstatement—Half-Truth—Concealment[82]

Flat falsehood makes adjudication easy. The statement that a color is white when the finder of fact determines it to be black presents no difficulty. But though a statement that the color is a "shade of gray" may be literally correct, the suggestion of "white" may be as dangerous as bald misstatement. The varieties of this sharp practice are many and they have served as the basis for a great many stop orders.[83]

Even though a statement is literally true, if it conveys a false impression, it is a half-truth, and failure to clarify that impression results in a failure to state facts necessary to make the statement not misleading.[84] When registrant's statements are technically adequate when viewed item by item, but the general effect creates a misleading picture in the minds of investors, the Commission can challenge the document as a whole.[85] Where an authoritative quotation from the study of a learned society is used by registrant in

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might nevertheless be of such importance that an average prudent investor would desire to have knowledge of it. On the whole, it would seem that, since the latter definition is broader, it is the preferable one.

[81]Matter of Mutual Industrial Bankers, Inc., 1 SEC 268 (1936). Rule 821 of the General Rules & Regulations under the Securities Act, provides that information in a prospectus may be expressed in condensed form. But if the prospectus summarizes in broad and misleading terms the nature of an offering, the Commission can challenge this summarization. Matter of National Educators Mutual Ass'n, Inc., 1 SEC 208 (1935). *Cf.* note 5, *supra.*

[82]See generally MacChesney and O'Brien, *Full Disclosure Under the Securities Act* (1937) 4 LAW AND CONTEMPORARY PROBLEMS 133.

[83]*Cf.* SEC v. Torr, 15 F. Supp. 315 (S. D. N. Y. 1936) where it was held that one who gives purportedly disinterested financial advice without disclosing that he is being paid for making such recommendations, omits to state a material fact, and is in violation of Section 17(a) of the Securities Act and Section 9(a) of the Exchange Act. It would seem that Section 17(b) of the Securities Act should have been relied upon by the learned court, since that section expressly forbids tipster activity.

[84]Matter of Howard, 1 SEC 6, 11 (1934) citing Rex v. Kylsant, [1932] 1 K. B. 442, 448. Matter of Lewis American Airways, Inc., 1 SEC 330 (1936). An analogous problem arises in deciding whether to delist securities registered under the Exchange Act. *Cf.* Matter of Hupp Motor Car Corp., 1 SEC 177 (1935) where mismanaging "insiders" reported to shareholders that the registrant's "cash balance has shown a gain." This, the Commission held, would lead stockholders to infer that operations had been on a profitable basis. And so, when the increase in cash was due to liquidation of inventories and the settlement of an outstanding claim at a discount, the statement was incomplete and misleading.

[85]Matter of National Educators Mutual Ass'n, 1 SEC 208 (1935).

its prospectus, editing it in such fashion as to make the matter asserted more favorable to registrant is misleading.[86] A statement of the discovery of a big oil well in the vicinity of registrant's property, and the omission to state that the well had proved largely worthless, constitutes the kind of half-truth which the Securities Act is designed to prevent.[87] The statement that "the Appellate Court has decided in favor" of registrant is misleading when registrant omits to state that the appellate court is an intermediate one from which further appeal has been taken.[88] It is misleading to use the names of well-known and successful persons to bolster registrant's enterprise, when those named know next to nothing of such enterprise. The impression is given to innocent investors that a reputable group is devoting its time and effort to building a highly worthy enterprise and that some safety to investors springs from that fact.[89] Prominence accorded by typography and position to the name and age of a corporate trustee is misleading to investors when the trustee has no control in the matter of actual investment of the trust funds, and registrant is a new and completely unknown investment trust. The Commission held this to be an unjustified attempt to trade on the name and reputation of the trustee.[90] Displaying prominently on the face of a bond the figures "$1000" is misleading though there appears below, but in much smaller type, the statement "consisting of $750 cash and $250 stock."[91] The assertion that a patent application stands allowed and that a patent should issue shortly is misleading when, in fact, the patent would become void unless a fee to renew it was paid within a short time after the filing of the registration statement.[92] The description in a mining prospectus of a manager as one who

[86]Matter of Gilpin Eureka Consolidated Mines, Inc., 1 SEC 752 (1936). Moreover the omission to state its source, the disclosure of which would have indicated to readers avenues to further information, constitutes the omission of a material fact.

[87]Matter of Herman Hanson Oil Syndicate, Securities Act Release No. 1555, Sept. 15, 1937.

[88]Matter of Mining and Development Corp., 1 SEC 786 (1936). Item 17 of Form A-1 requires a disclosure of all litigation pending that may materially affect the value of the security to be offered. Even though pleas in abatement or demurrers have been upheld in favor of registrant so that suits against registrant are as good as dead, and even though the suits are not important in registrant's estimation, registrant should set forth the factors reducing their importance, but it has no right to ignore them. Matter of Texas-Oklahoma Trust, Securities Act Release No. 1563, Sept. 23, 1937.

[89]Matter of National Educators Mutual Ass'n, Inc., 1 SEC 208 (1935); Matter of National Invested Savings Corp., 1 SEC 825 (1936).

[90]Matter of Registration Statement of Income Estates of America, Inc., Securities Act Release No. 1480, June 29, 1937.

[91]Matter of National Educators Mutual Ass'n, Inc., 1 SEC 208 (1935). Stating "cash surrender values" in this fashion is likewise a defect.

[92]Matter of Lewis American Airways, Inc., 1 SEC 330 (1936). The failure to disclose that the application was in fact abandoned and that it was a petition to revive the patent which was pending was also held to be a defect.

had served as "Engineer for the Austrian Government" is misleading when he was of that genus of "engineers" who drives locomotives.[93] When registrant is organized solely for the profit of its stockholders, the use of the word "mutual" in its name is incorrect.[94]

Where a portion of the proceeds from the sale of stock in a speculative venture was to be invested in bonds for twenty years when it then "should approximate the full amount of the shares," it is misleading to describe the plan as "protective" or as an "investment plan," when a stockholder then had the choice of simply retaining his stock *or* surrendering it and receiving back merely the purchase price paid twenty years before.[95] Computing the net income of a registrant which operates in a foreign country, without making allowance for the taxing effect of the foreign government's control over the exchange, is inaccurate and false.[96] The requirement that the balance sheet of a business acquired by registrant appear in its prospectus is not satisfied when registrant publishes its own balance sheet as of immediately after the acquisition.[97]

Half-truths are apt to be veiled behind excessive brevity. Item 28 of Form A-1 requires that registrant reveal the names of all persons owning beneficially more than 10% of registrant's stock. A bewildering maze of corporations, one controlling the other, simply places upon registrant the duty of full description so that beneficial ownership, no matter how remote and indirect, may be revealed to the investing public. Item 32 calls for the name of any underwriter of registrant controlled by it. Likewise an elaborate system of interlocking holding companies should be described, even though registrant entertained justifiable doubts as to whether it controlled the underwriter. If it so desired, registrant might disclaim control, but the failure to set forth full particulars was held to render the registration statement defective.[98] While ordinarily a brief description of registrant's business suffices, the statement that registrant was engaged in the "manufacture, sale, and repair of airships" creates a misleading impression where the history of

[93]Matter of Gilpin Eureka Consolidated Mines, Inc., 1 SEC 752 (1936). *Accord:* Matter of Sunset Gold Fields, Inc., Securities Act Release No. 1452, May 20, 1937 (electrical engineer). *Cf.* Mark Twain, "A mine is a hole in the ground owned by a liar." MAGRUDER & SECHLER-HUDSON, OUR NATIONAL GOVERNMENT 408.

[94]Matter of National Educators Mutual Ass'n, Inc., 1 SEC 208 (1935).

[95]Matter of Oil Ridge Oil & Refining Co., 1 SEC 225 (1935).

[96]Matter of Mining & Development Corp., 1 SEC 786 (1936).

[97]Matter of Mutual Industrial Bankers, Inc., 1 SEC 268 (1936).

[98]*Cf.* Matter of Equity Corp., Securities Act Release No. 1535, Aug. 24, 1937.

the company has been solely that of developing inventions.[99] And when the inadequacy of information springs from the disagreement among promoters as to the plan of business registrant proposes, the Commission will not allow the registration statement to become effective until an intention is clearly expressed therein.[100] The assertion that part of registrant's capital is to be devoted to the investigation of royalty properties is misleading, in the absence of an explanation that the sum may eventually be divided among the trustees if they so desire.[101] When registrant intends, at the time its statement becomes effective, to invest all or a large part of the proceeds of its issue in a company which it controls, the declaration that registrant will invest "in the securities of mercantile, industrial and financial corporations" is ambiguous to the point of falsehood.[102] Though the facts of an officer's former interest in property acquired from him by registrant may be true so far as they go, they are inadequate when it is not disclosed that the property had been bought by the officer at a nominal cost in a tax sale, that it had once belonged to companies this same officer had organized and which were now bankrupt, and that the officer was under obligation to allow stockholders of the former companies to buy registrant's stock at assumedly bargain prices.[103] The cost to promoters of property which they have conveyed to registrant for a large block of its shares must be revealed so that the promoters' profits may be gauged.[104] An investor who is solicited to purchase a security at the "market price" is entitled to knowledge of any artificial restraint upon the flow of the securities into the market and of any past or possible future artificial demand, so that he may determine for himself to what extent the market price represents the collective judgment of buyers and sellers as to the merits of the issue.[105] The statement that registrant's stock is to be offered "at the market" is misleading when registrant fails to disclose the

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[99]Matter of Lewis American Airways, Inc., 1 SEC 330, 343 (1936). *Accord*: Matter of Sunset Gold Fields, Inc., Securities Act Release No. 1452, May 20, 1937. The duty to be not unduly economical with the truth antedates the Securities Act by a respectable span of years. *Cf.* New Brunswick Co. v. Muggeridge, 1 Dr. & Sm. 363, 381-2, 62 Eng. Rep. 418, 425 (1860).

[100]Matter of International Investors Fund System, Inc., 1 SEC 461 (1936).

[101]Matter of Wee Investors Royalty Co., 1 SEC 202 (1935).

[102]Matter of Corporate Leaders Securities Co., Securities Act Release No. 1534, Aug. 21, 1937. *Cf.* Matter of Consolidated Funds Corp., Securities Act Release No. 1548, Sept. 9, 1937 where no deficiency was found, even though strong inferences existed of an intention to increase investments in certain securities.

[103]Matter of Plymouth Consolidated Gold Mines, Ltd., 1 SEC 139 (1935). *Cf.* Matter of Bankers Union Life Co., Securities Act Release No. 1278, Feb. 23, 1937.

[104]Matter of La Luz Mining Corp., 1 SEC 217 (1935).

[105]Matter of Rickard Ramore Gold Mines, Ltd., Securities Act Release No. 1476, June 16, 1937. *Cf.* SEC v. Otis, 18 F. Supp. 100 (D. C. N. D. Ohio, 1936) and Singleton v. Harriman, 152 Misc. 323, 272 N. Y. Supp. 905 (1933).

existence of a "thin" market and that the action of the stock has been volatile and subject to marked fluctuations, and also that the issue is peculiarly susceptible to artificial price control, if not manipulation, by the underwriter.[106]

The attitude of the older law of deceit toward opinion and prophecy finds no counterpart in the SEC cases. A prophecy known to be untrue as of the time it is made is a false statement of fact inasmuch as it misrepresents the mind of the person making the prophecy.[107] Valuations purporting to follow certain standards, even though in the final analysis they represent merely informed judgments, nevertheless are representations that these standards have been followed. If they are not fairly observed, the valuations finally arrived at are in essence misrepresentations of fact, because they falsely describe the basis upon which judgment has been exercised.[108] While some degree of tolerance may be permitted in estimating the profits of a new enterprise, the fact that registrant's estimate is far out of line with the experience of established companies in the same industry is misleading in the absence of data which will substantiate registrant's unusual estimate.[109] The use of a sham contract in a registration statement to hold forth false promise of profit as an inducement to investors to purchase registrant's stock amounts to a misleading statement of material facts.[110]

The temptation to label less conservative securities as bonds is an obvious one. The Commission has held that when securities represent only unsecured claims against the assets of a corporation, the term "bonds" is misleading, but that "debentures" is acceptable.[111] When there is no obligation to pay a fixed sum of money with stated interest, it is misleading to describe a speculative mining stock as having a "bond feature" which puts it in the "category of the most respectable bond."[112] The use of the terms "ma-

[106]Matter of Canusa Gold Mines, Ltd., Securities Act Release No. 1507, July 15, 1937.

[107]Matter of Commonwealth Bond Corp., Inc., 1 SEC 13 (1934). But *cf.* State v. Clarke (U. S. L. Week, Aug. 24, 1937, App. Div. N. Y.).

[108]Matter of Haddam Distillers Corp., 1 SEC 37 (1934); Matter of Continental Distillers & Importers Corp., 1 SEC 54 (1935); Matter of Big Wedge Gold Mining Co., 1 SEC 98 (1935).

[109]Matter of American Kid Co., 1 SEC 694 (1936). The same principle was applied with respect to costs of manufacture, overhead and selling expenses, and other items in the operating statement.

[110]Matter of Brandy-Wine Brewing Co., 1 SEC 123 (1935) (contract impossible of performance because of deliberate and fantastic overestimate of natural resources, because of the impossibility of marketing, and because of financial irresponsibility of other contracting party).

[111]Matter of Major Metals Corp., Securities Act Release No. 1280, Feb. 25, 1937.

[112]Matter of Oil Ridge Oil & Refining Corp., 1 SEC 225 (1935). It was also held that the use of the word "guarantee" is misleading when there is no

turity" or "maturity value" in connection with an investment subject to an element of large contingency (such as the market value of underlying securities) is also misleading. In other words, the use of a common term in a sense differing substantially from its generally accepted meaning has in itself the capacity to mislead.[113]

Through the requirements of its forms[114] the Commission has gone far to relieve registrants of the mental distress of deciding for themselves how deeply into their affairs they must delve to satisfy the duty of full disclosure. Items on the various registration forms number as many as fifty or more. But registrant's obligation to the investing public does not necessarily end with its yielding all the information called for by the forms. The peculiarities of registrant's structure, activities, or past may impose on it the duty to reveal facts not expressly required by the forms. Or for the same reasons, an answer to an item in the form itself sufficient for one issuer may be quite inadequate for another.

What facts beyond those explicitly called for has the Commission demanded to forestall a stop order? It has been held that where registrant's mine is located in a region marked by erratic distribution of ore values, the investor is entitled to some description of the mineralization so that he may judge the hazards of the undertaking.[115] Excessively optimistic reports of a mining engineer, even though perfectly sincere, should be accompanied with a statement that all the development work had not indicated the positive presence of any ore in commercial quantities, when such is the case.[116] Any registrant which bases predictions of mineral abundance upon a diving instrument known as a "doodle bug" must clearly state that it is not considered by any recognized authority to be of any use whatever in locating oil or other minerals.[117] Failure to disclose that registrant's capital is being used for the support of enterprises other than those listed in the registration statement is a material omission.[118] Item 27 in Form A-1, calling for a detailed statement of specific purposes to which the proceeds of the issue are to be devoted, is not satisfied by general answers such as "development and completion to marketable state"

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obligation of indemnity or warranty or undertaking to pay the debt of another in case he does not pay.

[113]Matter of Registration Statement of Income Estates of America, Inc., Securities Act Release No. 1480, June 29, 1937.

[114]These forms are drawn up pursuant to Section 7 and Schedules A and B of the Securities Act.

[115]Matter of Snow Point Mining Co., 1 SEC 311 (1936).

[116]Matter of Rickard Ramore Gold Mines, Ltd., Securities Act Release No. 1476, June 16, 1937.

[117]Matter of La Luz Mining Corp., 1 SEC 217 (1935); Matter of Herman Hanson Oil Syndicate, Securities Act Release No. 1555, Sept. 15, 1937.

[118]Matter of American Gyro Co., 1 SEC 83 (1935).

of aircraft, or "general corporate purposes," although the latter might be sufficient for small amounts.[119] Where additional financing will be necessary to operate registrant's proposed business on a profitable basis, this must be disclosed. Failure to reveal that no provision is made in its articles of trust for the distribution of a considerable part of the earnings of an "investment trust" constitutes the omission of a highly material fact.[120] The absence of statements in a prospectus setting forth in simple language the consequences of certain features of registrant's financial structure, such as a provision that promoters are to receive an unusual share of profits, has the effect of portraying an essentially inadequate and misleading picture to the investor.[121] Failure to reveal that the charter forbade cumulative voting is an omission to state facts required in answer to Item 53 of Form A-1 calling for the description of voting rights of the security to be issued.[122]

A registrant whose stock-selling scheme represents that a profit may be made of over $700 on a $1 investment is guilty of an omission of material fact when it fails to make clear that only one person in a thousand can possibly receive such a return, and that if a substantial number of investors carry out the scheme, the $700 profit could never be realized.[123] It has also been held that failure to reveal that the only purpose of a "step-up" plan was to facilitate registrant's stock sales results in the misleading impression that the increasing worth of the corporation's assets justifies the increase in price.[124]

The failure of a protective committee to give at least a brief particularization of the prior connection between itself and its depositary is a deficiency justifying the issuance of a stop order.[125]

[119]Matter of Lewis American Airways, 1 SEC 330, 344 (1936).

[120]Matter of Wee Investors Royalty Co., 1 SEC 202 (1935).

[121]Matter of National Educators Mutual Ass'n, Inc., 1 SEC 208 (1935) (promoters to receive 60% of profits, leaving balance to investors in a "mutual" enterprise). *Cf.* Matter of Plymouth Consolidated Mines, Ltd., 1 SEC 139, 146 (1935) where the Commission declared, "So much is siphoned away by promoters from the money contributed by investors, that an almost negligible equity is the return for the cash contributed by the public. When that situation occurs and is concealed by the way in which promoters, selling property to themselves through the fiction of a corporation, acquire huge blocks of salable stock for property for which they paid little or nothing, the type of full disclosure demanded by the Securities Act calls for an adequate and succinct disclosure of the effects of these strange and curious proceedings to the investor."

[122]Matter of Lewis American Airways, 1 SEC 330 (1936).

[123]Matter of Wee Investors Royalty Co., 1 SEC 202 (1935) (chain-selling scheme). The Commission also found a deficiency in the omission to point out that the scheme was in possible violation of Postal Regulations.

[124]Matter of Snow Point Mining Co., 1 SEC 311 (1936); Matter of Avocalon Extension Syndicate, 1 SEC 657 (1936); Matter of Old Diamond Gold Mines, Ltd., Securities Act Release No. 1576, Oct. 8, 1937.

[125]Matter of Howard, 1 SEC 6 (1934). The means whereby notice of adoption of a plan is to be given to depositors must be stated

When it had previously reorganized the corporation whose bonds it was now soliciting, the committee was required to make full disclosure of the profits it realized in the earlier reorganization. Nor could the fact that registrant gained control of the reorganized corporation be concealed.[126] Failure of registrant to disclose its predecessor in business to enable prospective investors to understand registrant's background results in inadequate information.[127] To leave the public with the impression that registrant is a company which has been in existence for several months and which has already raised considerable capital is misleading when registrant's hand-to-mouth existence is not adequately portrayed.[128] To describe a company as being on a "dividend-paying basis" is misleading when the dividends are paid out of capital and the company is in fact not earning enough to pay costs of operation.[129] Imminent cancellation of registrant's lease which will result in severe losses is contrary to representations that registrant is a continuing successful and profitable enterprise.[130]

Of course the requisites of truthful statement and full disclosure are not limited to the body of the registration statement.[131] The Act provides no specific arrangement for prospectuses[132] but artful presentation, notwithstanding all the essential facts are presented at some point or another in the prospectus, may be subject to condemnation. Failure to limit or qualify an inexact statement at the very point where it is made renders the prospectus deficient, even though the statement is susceptible of correction from information supplied elsewhere in the prospectus. A format designed to discourage reading, such as long paragraphs of dreary legalistic language heightens the seriousness of this defect.[133] Though information is correctly given in the registration statement, but, through typographical error, incorrectly stated in the prospectus, it may nevertheless be a material misstatement.[134] Reports, maps,

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[126]"The intrinsic fiduciary relationships existing between a protective committee and the depositing bondholders call for full and fair disclosure of these facts." Matter of Commonwealth Bond Corp., 1 SEC 13, 18 (1934).

[127]Matter of Mutual Industrial Bankers, Inc., 1 SEC 268 (1936).

[128]Matter of Lewis American Airways, Inc., 1 SEC 330 (1936).

[129]Matter of Golden Conqueror Mines, Inc., Securities Act Release No. 1520, Aug. 6, 1937.

[130]*Ibid.*

[131]General Rules & Regulations under Securities Act, Rules 560-563 provide for incorporation by reference of various exhibits as answers to items in the registration statement.

[132]For an especially valuable statement concerning the mode of condensing the description of securities in prospectuses, see the Opinion of the Director of the Division of Forms & Regulations, Securities Act Release No. 1503, July 12, 1937. *Cf.* note 81, *supra.*

[133]Matter of Registration Statement of Income Estates of America, Inc., Securities Act Release No. 1480, June 29, 1937.

[134]Matter of Mutual Industrial Bankers, Inc., 1 SEC 268 (1936).

articles of trust and by-laws, filed as part of a registration statement may contain material untruths or fail to state material truths justifying the issuance of a stop order.[135] Information included in the registration statement, even though not required by the particular form, must nevertheless meet standards of accuracy imposed on required information.[136] At least one of two contradictory statements cannot be true, and the Commission may issue a stop order without a finding as to which is false.[137]

As a corollary matter, the Commission has insisted upon the correct use of technical terms. The use of "words of art" by an expert which is suggestive to a layman of an idea substantially different from the artistic meaning of the language may be sufficiently misleading to justify a stop order.[138] In the appraisal of mining property, a clear distinction must be kept between "proven," "probable" and "possible" ore.[139] The inclusion of "possible" ore in making valuations is not approved technique, inasmuch as possible ore, being merely an expression of inferences drawn from non-quantitative geological data, is not subject to expression in terms of dollars and cents.[140]

Since technical language must be correctly used, it follows that an expert's report couched in high-sounding pseudo-scientific, and meaningless phrases designed to impress the uninformed will be considered deficient.[141] But non-technical language may not be used to veil unpleasant truths. It is thus within the scope of the Commission's duties to insist that all plans for financing shall be so described as to reveal their essential characters, whether speculative or otherwise.[142] The complexity of an offering, its unfair collateral presentation, and the inexpert type of investor at whom it is directed tend to resolve any doubts with respect to the materially deficient character of a prospectus against the registrant.[143]

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[135]Matter of Continental Distillers & Importers Corp., 1 SEC 54 (1935) (appraisal report); Matter of Big Wedge Gold Mining Co., 1 SEC 98 (1935) (mining engineer's report); Matter of Plymouth Consolidated Gold Mines, Ltd., 1 SEC 139 (1935) (maps, insofar as they reflect misstatements in engineer's report); Matter of Wee Investors Royalty Co., 1 SEC 202 (1935) (articles of trust and by-laws).

[136]Matter of Unity Gold Corp., 1 SEC 25 (1934). The same is true as to prospectuses. Matter of Paper Sales Co. of Detroit, Inc., Securities Act Release No. 1556, Sept. 16, 1937.

[137]Matter of Wee Investors Royalty Co., 1 SEC 202 (1935); Matter of Snow Point Mining Co., Inc., 1 SEC 311 (1936).

[138]Matter of Rickard Ramore Gold Mines, Ltd., Securities Act Release No. 1476, June 16, 1937.

[139]Matter of Gilpin Eureka Consolidated Mines, Inc., 1 SEC 752 (1936).

[140]Matter of Mining & Development Corp., 1 SEC 786 (1936).

[141]Matter of Franco Mining Corp., 1 SEC 285 (1936).

[142]Matter of Major Metals Corp., Securities Act Release No. 1280, Feb. 25, 1937.

[143]Matter of Registration Statement of Income Estates of America, Inc., Securities Act Release No. 1480, June 29, 1937.

Misrepresentations to old shareholders that its company is operating successfully are all the more vicious when made to induce them to invest in securities of a new project being promoted by those in control of the old company.[144]

As a distinct contribution to the peace of mind of registrants and those who join in preparing and filing their statements, the Commission has by Rule 502 provided that "information . . . need be given only in so far as known or reasonably available to registrant." Incomplete information may be submitted if registrant adds a disclaimer of responsibility for its accuracy or completeness and in addition, states that unreasonable effort and expense would be necessary to render it complete.[145]

Matters of Accounting[146]

The Accountant

The belief was early expressed that "the evolution of model financial accounting methods, with which the Commission is . . . charged, is well calculated to have far-reaching beneficial effects on American corporate practices."[147] This charge the Commission has assumed with vigor. It has not hesitated to reprimand an accountant who has shown a shortage of professional independence and integrity.[148] Of course, objectivity is implicit in the concept of an "independent" accountant. "He who as a result of connivance with, or loyalty or subservience to his client, purposely or recklessly misrepresents the facts, cannot be said to qualify as an 'independent' expert. Protection of investors in these situations requires not only that these fiduciaries be free of the entangling alliances which relational and contractual connections with registrants frequently engender, but also that they approach their task with complete objectivity—critical of the practices and procedures of registrants, and unwilling to aid and abet in making statements

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[144]Matter of Golden Conqueror Mines, Inc., Securities Act Release No. 1520, Aug. 6, 1937.

[145]For the effect of this on the "absolute" liability of issuers, see Matter of Howard, 1 SEC 6, 10, footnote. *Cf.* also note 8, *supra.*

[146]On April 1, 1937, the Commission began issuing releases under the caption "Accounting Series" for the publication of "opinions on accounting principles for the purpose of contributing to the development of uniform standards and practice in major accounting questions." On this topic see Sanders, *Accounting Aspects of the Securities Act* (1937) 4 LAW AND CONTEMPORARY PROBLEMS 191.

[147]Frankfurter, *Federal Securities Act: II,* (Aug. 1933) 8 FORTUNE 53, 108.

[148]Matter of National Educators Mutual Ass'n, Inc., 1 SEC 208 (1935). The Commission has ordered disparaging language stricken from its opinions when later convinced that there was no intention to mislead the investing public. Matter of National Educators Mutual Ass'n, Inc., 1 SEC 279 (1936). As to an "expert's" lack of requisite knowledge and skill, *cf.* Matter of Gilpin Eureka Consolidated Mines, Inc., 1 SEC 752 (1936).

which the facts do not warrant."[149] The Commission has recognized the fact that an accountant may have a continuing pecuniary interest, as distinguished from the usual fixed fee arrangement, which is so small or indirect as to give rise to no inference of loss of objectivity. But where the continuing interest is substantial, such as a claim to a percentage of registrant's gross sales for a year, the accountant has too close an identity with his client's financial destinies to be satisfactorily independent. Certification by an accountant who is a shareholder and an unsalaried officer of registrant does not satisfy the requirement of independence.[150] The partner or employee of an accountant disqualified under Rule 650 to certify to a balance sheet is also disqualified.[151] And the statement by such a person that his relationship with registrant is "the usual relationship of independent accountants to their clients" is an untrue statement of a material fact. It is, moreover, incumbent on the accountant to disclose all of his interests in the registrant company even though acquired independently of the contract for preparation of the report.[152]

The accountant's certification is a representation of material fact. It is material because it "gives a minimum of protection against half-truths which otherwise would more easily creep into financial statements."[153] Unqualified certification amounts to a

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[149]Matter of American Terminals & Transit Co., 1 SEC 701, 707 (1936); Matter of Metropolitan Personal Loan Co., Securities Act Release No. 1594, Oct. 28, 1937.

[150]Matter of Cornucopia Gold Mines, 1 SEC 364 (1936). *Accord*: Opinion of Chief Accountant, Accounting Series Release No. 2, May 6, 1937, where it was said that a *firm* of accountants was not independent if the value of a partner's holdings in registrant was significant with respect to registrant's total capital or his personal fortune. See General Rules & Regulations under Securities Act, Rules 650 and 651. *Accord*: Matter of Plymouth Consolidated Gold Mines, Ltd., 1 SEC 139 (1935) (expert was interested in the prospect of being employed regularly by registrant). The Commission does not require registrant to file a report by an "independent" engineer. Disclosure of all material facts concerning the relationship between the engineer and the company is all that is necessary. Matter of Livingston Mining Co., Securities Act Release No. 1363, April 5, 1937. The word "employed" as used in Item 50 of Form A-1 requiring the names of experts is used in a broad sense and is not confined to the master-servant relationship. Although for other purposes he may be an independent contractor, he is for the purposes of the particular item in the registration statement, included in the word "employed." Matter of Cornucopia Gold Mines, 1 SEC 364 (1936).

[151]Matter of Rickard Ramore Gold Mines, Ltd., Securities Act Release No. 1476, June 16, 1937.

[152]Matter of Cornucopia Gold Mines, 1 SEC 364, 366-8 (1936).

[153]*Id.* at 367. Section 8(e) provides that the Commission may require the production of a balance sheet or income statement, certified to by a public or certified accountant approved by the Commission. And Rule 455 of Rules & Regulations under the Securities Act states that the term " 'certified' . . . means certified by an independent public or independent certified public accountant."

representation that a reasonable investigation has been made.[154] When an accountant examines nothing more than the papers filed with the registration statement and submits an incomplete balance sheet, he has not made a reasonable investigation.[155] Certification of the balance sheet of a small loan company, most of the assets of which by their nature are readily convertible into cash or are pledgible, is of little or no value without an actual examination or verification of such assets.[156] When an accountant attempts to set up books of accounts from memory, not knowing even who was authorized to make expenditures for the corporation, or when he relies on unverified information furnished by a controlling promoter-officer of registrant, his certification is false in stating that it is based upon the books and records of the corporation.[157] If he lacks access to the minutes book and to proper disbursement vouchers, he should qualify his certificate by saying the basis upon which he made his audit, and the reasons why such investigation is deemed by him to be reasonable.[158] Where books and records do not disclose an adequate basis for allocation of expenses, this should be stated or an inquiry to determine the allocation should be made. The accountant's failure to inquire or to qualify his certificate casts doubt upon the adequacy of the audit.[159]

Rule 651 requires that the certificate shall state the accountant's opinion of the accounting principles and procedure followed by the registrant. The failure of an accountant to express the opinion that certain entries were improper makes his description of the transactions entered materially deficient.[160] The statement that registrant followed generally recognized procedure except that all cash was turned over to controlling individuals who made disbursements from their pockets, indicated that this was not in accordance with accepted procedure. The Commission suggested that a more explicit statement would be more in keeping with the

[154]Rule 651 contemplates the "procedure which independent public accountants would ordinarily employ in the course of a regular annual audit."

[155]Matter of Big Wedge Gold Mining Co., 1 SEC 98 (1935). The balance sheet must be complete and reasonably informative to investors. Matter of Lewis American Airways, Inc., 1 SEC 330 (1936). Even though the statement that registrant had not published a balance sheet would have been sufficient, nevertheless if registrant submits an *operating statement*, it must be complete. Matter of Commonwealth Bond Corp., 1 SEC 13 (1934) (taxes omitted).

[156]Matter of Metropolitan Personal Loan Co., Securities Act Release No. 1594, Oct. 28, 1937.

[157]Matter of National Boston Montana Mines Corp., Securities Act Release No. 1409, April 30, 1937.

[158]Matter of Franco Mining Corp., 1 SEC 285 (1936).

[159]Matter of Lewis American Airways, Inc., 1 SEC 330 (1936).

[160]Matter of Metropolitan Personal Loan Co., Securities Act Release No. 1594, Oct. 28, 1937.

"spirit of the rule" and more informative to investors, especially because vouchers could not be found in many cases.[161]

Inflated Values and Promoters

Statutory provisions in the state of registrant's incorporation making values fixed by directors conclusive for certain purposes in the absence of fraud, cannot save the valuation from being "tested for truth under the standards set by the Securities Act."[162] Where the basis of valuation of property is unsound, the value set in the balance sheet becomes itself untrue.[163] The determination by an engineer of the "prospective" value of mining property, when the venture is highly speculative, affords no scientific basis for valuation and, of course, cannot truthfully be advanced as the value of the consideration given for the mine, and thus entered as its cost.[164] Failure to state in describing a mine that parts were inaccessible creates the impression that the engineer had been able to visit all workings and use facts there observed to form his judgment. This results in an omission to state material facts necessary to make his report not misleading.[165] When good engineering practice would require well over a thousand samples of vein material to afford a valid basis for appraisal, the computations of an engineer who calculates on the basis of only a few samples are unreliable.[166] The property account is also misleading where it is based upon a valuation for the entire productive life of the mine, without an adjustment for present worth.[167]

The Commission has given strong indication that it is improper to use replacement cost alone to set up property values of an ordinary commercial enterprise against which securities are issued to a controlling group of promoters.[168] An appraisal of the "sound value" of land which disregards its recent sale price, its tax appraisal, and the condition of the local real estate market is unreliable.[169] Filing an appraisal which registrant knew included

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[161]Matter of Lewis American Airways, Inc., 1 SEC 330, 338 (1936).

[162]Matter of Brandy-Wine Brewing Co., 1 SEC 123 (1935).

[163]Matter of Franco Mining Corp., 1 SEC 285 (1936); Matter of Gilpin Eureka Consolidated Mines, 1 SEC 752 (1936) (use of arithmetical instead of weighted average).

[164]Matter of Unity Gold Corp., 1 SEC 25 (1934). The false effect of a valuation figure is not mitigated by an admission that states with complete frankness that the asset was overvalued. Matter of Mining & Development Corp., 1 SEC 786 (1936).

[165]Matter of Franco Mining Corp., 1 SEC 285 (1936).

[166]Matter of La Luz Mining Corp., 1 SEC 217 (1935).

[167]*Ibid.*

[168]Matter of Haddam Distillers Corp., 1 SEC 37 (1934). *Cf.* Atlanta, Birmingham & Coast R. R. Co. v. United States, 296 U. S. 33, 39, 80 L. ed. 25, 29 (1935) and Matter of Arkansas-Missouri Power Corp., Holding Companies Act Release No. 718, June 28, 1937.

[169]Matter of Continental Distillers & Importers Corp., 1 SEC 54 (1935).

buildings and equipment no longer in existence or destined for the junk heap at the effective date of the registration statement, without full disclosure of those facts, is a misrepresentation and "extremely reprehensible."[170]

Watering stock through over-valuation of physical property is a favorite promoter's device.[171] The Commission has held that the registrant's duty consists simply of pressing *concealed* water from the balance sheet, so that the investor may judge for himself as to whether debit items such as "Promotional Expenses" represent anything of value.[172] Payments to promoters cannot be concealed by a complicated chain of transactions among interlocking corporations without rendering registrant's response to Item 39 of Form A-1 deficient in a material respect.[173] Promoter's fees,[174] experimental costs,[175] and charges for the preparation of the registration statement[176] must be listed separately from expenditures representing the consideration paid for physical assets.[177] Large promoter's profits from the sale of property to a corporation should not be included in the cost of the property, but should be segregated out as promoter's fees.[178] Failure to disclose the cost to promoters of property conveyed by them to registrant is an omission of a material fact.[179] Property listed at the par of shares issued as con-

[170] *Id.* at 81.

[171] On this topic see MacChesney, *The Securities Act and the Promoter* (1936) 25 CALIF. L. REV. 66; Note (1936) 49 HARV. L. REV. 785.

[172] Matter of Haddam Distillers Corp., 1 SEC 48 (1934).

[173] Matter of Equity Corp., Securities Act Release No. 1535, Aug. 24, 1937.

[174] Matter of Unity Gold Corp., 1 SEC 25 (1934); Matter of Yumuri Jute Mills Co., Securities Act Release No. 1303, March 4, 1937; Matter of Rickard Ramore Gold Mines, Ltd., Securities Act Release No. 1476, June 16, 1937. The Commission has not decided whether promotional expenses may be capitalized or whether they must be treated as a deferred or prepaid expense. *Cf.* Matter of Sunset Gold Fields, Inc., Securities Act Release No. 1452, May 20, 1937. A depreciation charge on real estate may be capitalized by a company in the development state. See Lewis American Airways, 1 SEC 330, 339 (1936).

[175] Matter of Haddam Distillers Corp., 1 SEC 37 (1934).

[176] "The inference is that this inflation of cost . . . is to conceal the true disparity between what the [vendor-promoter] gave for the property and what he is to receive from the corporation." Matter of Snow Point Mining Co., Inc., 1 SEC 311, 315 (1936).

[177] When the inclusion of many of the sums in the cost of acquiring property by a promoter for registrant is of doubtful propriety, a detailed statement should be made by the corporation. Matter of Snow Point Mining Co., Inc., 1 SEC 311 (1936).

[178] Designating such profits "broker's fee" is no escape. Where a promoter received stock the face amount of which exceeded by five-fold the price received by the vendor of property in a sale to the corporation negotiated by the promoter, the Commission found that the facts led "irresistibly to the conclusion" that the shares were paid as promoter's fees. Matter of Continental Distillers & Importers Corp., 1 SEC 54 (1935).

[179] Matter of La Luz Mining Corp., 1 SEC 217 (1935); Matter of Franco Mining Corp., 1 SEC 285 (1936); Matter of Mining & Development Corp., 1 SEC 786 (1936). It is at least necessary, to avoid a misleading effect, to state that the vendor-promoter was in control of the vendee-corporation. Matter of Continental Distillers & Importers Corp., 1 SEC 54 (1935).

sideration therefor is falsely valued when the figure set is far in excess of the contemporaneous cost to the vendors. And an appraisal at "sound value" which is larger than the balance sheet figure and greatly exceeds the price recently paid by promoters is all the more misleading.[180] When subsequent sales of the stock issued show it on the market at considerably less than par, an appropriate discount must be made in the valuation set upon the properties for which it is issued. The "value of the consideration given for the property should be measured by the value of the property acquired and this latter figure then be stated as the cost of the property."[181]

When there is a concurrent "donation back" to the issuer, the value of the donated stock cannot truthfully be included in valuing the property.[182] The value of stock issued as consideration for the seller's promise to spend that amount in improving the property cannot be regarded as an item in its cost.[183] And a concurrent option to repurchase at a figure materially lower than the value attributed to the shares renders false the valuation placed on the property.[184]

Assigning a value to stock creates the impression that it was issued for cash, services, or property and unless issued for such consideration, the impression created is false.[185] When some of registrant's property has been valued at the par of stock given, and other property has been valued at many times par, this discrepancy must be indicated to show that the dollar values placed on the shares issued for each type of asset were purely arbitrary.[186] Attributing a "stated value" of $50 a share to stock which is sold to promoters at ten cents and which will never reach a value of $50 under any normal probabilities of operation is highly misleading.[187]

The issuance of shares to a promoter for services implies that his services were evaluated in good faith by registrant's directors and that they were fairly and reasonably worth the value of the

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[180]Such a statement "may give a prospective investor a false impression of conservatism and lead him away from inquisitiveness as to the manner of determining 'cost'." Matter of Continental Distillers & Importers Corp., 1 SEC 54, 79 (1935).

[181]Matter of Unity Gold Corp., 1 SEC 25, 34 (1934); Matter of Canusa Gold Mines, Ltd., Securities Act Release No. 1507, July 15, 1937.

[182]Matter of Unity Gold Corp., 1 SEC 25, 30-33 (1934).

[183]Matter of Continental Distillers & Importers Corp., 1 SEC 54 (1935).

[184]Matter of Yumuri Jute Mills Co., Securities Act Release No. 1303, March 4, 1937.

[185]Matter of Franco Mining Corp., 1 SEC 285 (1936).

[186]Matter of Lewis American Airways, Inc., 1 SEC 330 (1936).

[187]Matter of National Educators Mutual Ass'n, Inc., 1 SEC 208 (1935). *Accord*: Matter of Plymouth Consolidated Gold Mines, Ltd., 1 SEC 139 (1935) (statement that offering price was $1 when issuer was under contract to offer a portion at twenty-five cents plus one share of worthless stock).

stock given. But where the valuation set on promotional services is so grossly excessive as to be outside the range of any reasonable difference of opinion, the Commission has insisted that part of the stock issued must be listed as a gift to the promoter. The entry of the full amount for "promotional services" as an asset on registrant's balance sheet is an untrue statement of material fact.[188] When stock is issued to a promoter pursuant to a pre-incorporation agreement for dividing control, which makes no reference to the value of property conveyed or services performed by the promoter, it is a misrepresentation to list "Promotion Expenses" as equal to the par value of the shares issued.[189] The consideration for the shares must in fact be the promoter's services. *Ex post facto* directors' action will not make the statement that the stock was issued for services (or property) true.

Debits

The Commission has dealt with a variety of problems arising from the asset side of the balance sheet. Including among current assets of a *pro forma* balance sheet "proceeds of stock presently to be issued" when there is no firm commitment to take them is held highly misleading.[190] It is also misleading to claim the total amount payable on subscriptions to bonds as an asset item without indicating that the sum might be reduced by forfeiture of the bonds with no further liability on the part of the defaulting subscribers.[191] It is a misrepresentation to list under current assets a sum stated to be a debt owing to registrant without disclosing its apparent worthlessness because of the financial irresponsibility of the debtor and because the collateral he posted had no apparent realizable value. Inclusion in notes and accounts receivable of items, a substantial amount of which were known to be uncollectible or were considered doubtful of collection, without disclosing that an adequate reserve had not been provided thereagainst is grossly improper.[192] To include as "Marketable Securities" among current assets the common stock of an insolvent com-

[188]Matter of Brandy-Wine Brewing Co., 1 SEC 123 (1935). Whether the Commission will rule other excessive promotional "compensations" to be partly gifts is not clear. No such approach was taken in Matter of Avocalon Extension Syndicate, Ltd., 1 SEC 657 (1936), where there was an underwriter's commission of 50%.

[189]Matter of Franco Mining Corp., 1 SEC 285 (1936); Matter of Snow Point Mining Co., Inc., 1 SEC 311 (1936).

[190]Matter of Haddam Distillers Corp., 1 SEC 48 (1934); Matter of Continental Distillers & Importers Corp., 1 SEC 54 (1935); Matter of National Boston Montana Mines Corp., Securities Act Release No. 1409, April 30, 1937 (unissued notes).

[191]Matter of Bankers Union Life Co., Securities Act Release No. 1278, Feb. 23, 1937.

[192]Matter of Metropolitan Personal Loan Co., Securities Act Release No. 1594, Oct. 28, 1937.

pany is a false statement of registrant's financial condition,[193] and the listing as an "Investment" of shares not purchased for investment purposes, but accepted in settlement of an obligation due to registrant from the issuer of the securities, is untrue.[194] When registrant accepts a mortgage, which its debtor held as mortgagee, in cancellation of a debt, registrant may not consider as a profit the difference between the face amount of the mortgage and the amount of the discharged debt. Until registrant sells the mortgage, or payment is made by the mortgagor, no income can be considered as having been realized.[195]

It is inaccurate to carry as an asset the property of a subsidiary, even though entirely owned by registrant. But even if this practice be conceded to state the situation correctly in substance, it is a misrepresentation of fact to list as an asset on the same balance sheet the stock of the same subsidiary.[196] Adding its own operating expenses to the cost of stock in subsidiary companies, thereby making the investment appear to be more valuable, renders false registrant's statement that "the character . . . of the management" should assure success. Similarly, carrying, as an investment asset, the loss registrant sustained in the purchase and sale of subsidiaries has the same effect.[197]

Setting up property as an asset without disclosing that it was in jeopardy because of the vendor's right to avoid the sale on registrant's default in payment is false and misleading.[198] The defect should be cured by the addition of an item for "Contingent Liabilities" or "Secured Debts" on the credit side of the balance sheet. Valuing repossessed automobiles at a figure arrived at by adding the cost of necessary repairs to the balance of loans due on them is misleading, when no reserve is set up to provide for a loss which ought to be anticipated on the basis of past liquidation experience.[199] A figure which includes the cost of repairs and improvements and ignores depreciation, does not represent the value of machinery as of the date of the balance sheet.[200] Likewise the in-

[193]Matter of American Gyro Co., 1 SEC 83 (1935); Matter of Metropolitan Personal Loan Co., Securities Act Release No. 1594, Oct. 28, 1937.

[194]Matter of American Gyro Co., 1 SEC 83 (1935).

[195]Matter of General Income Shares, Inc., 1 SEC 110 (1935). *Cf.* Matter of Metropolitan Personal Loan Co., Securities Act Release No. 1594, Oct. 28, 1937.

[196]Matter of Plymouth Consolidated Gold Mines, Ltd., 1 SEC 139 (1935). *Accord*: Matter of Continental Distillers & Importers Corp., 1 SEC 54 (1935) (water rights considered in valuing land and then stated as separate and independent assets).

[197]Matter of American Credit Corp., 1 SEC 230, 234 (1935).

[198]Matter of Mining & Development Corp., 1 SEC 786 (1936); Matter of Canusa Gold Mines, Ltd., Securities Act Release No. 1507, July 15, 1937.

[199]Matter of Metropolitan Personal Loan Co., Securities Act Release No. 1594, Oct. 28, 1937.

[200]Matter of American Gyro Co., 1 SEC 83 (1935).

clusion of architects' fees in a "sound value" appraisal of buildings without a proportionate reduction of the item for depreciation is improper.[201] The designation under "Fixed Assets" as "Property and Plant" of an option to purchase realty is false and misleading. The recognizable asset is measured by the amount of the advance payment and consists of a claim upon the other party involved, rather than in outright ownership of the land. "It is not in accordance with accepted accounting practice to set up as an asset the full value of property partially paid for and to which title has not yet been obtained even though the liability side of the balance sheet reflects the amount still due."[202]

Failure to disclose on the balance sheet that an asset has been pledged by registrant is a misleading omission.[203] The fact that the pledge was shown in a balance sheet of a date two months later does not cure the defect.[204] Nor can comments found elsewhere in the registration statement be relied upon to qualify the effect of the balance sheet.[205]

A new concern proposing to manufacture a new contrivance which has not proved to be a success cannot set a "good will" value on its product without misleading investors. The Commission held that "mere speculation as to the existence of intangible values is not sufficient."[206] Similarly, "Unrealized Appreciation" of assets is essentially an estimate of the difference between the cost of property and its present real worth. In *Matter of Consolidated Mines Syndicate*[207] the Commission found it unnecessary to decide whether the inclusion in the balance sheet of unrealized appreciation was proper. But, the Commission pointed out, since it is dependent upon valuation, inaccurate evaluation invalidates the appreciation figure.

Where the results of experimentation in the development of inventions are unsuccessful, the development costs should not be carried as an asset, but ought to be written off as a loss.[208] Whether

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[201] Matter of Continental Distillers & Importers Corp., 1 SEC 54 (1935).

[202] Matter of Paper Sales Co. of Detroit, Inc., Securities Act Release No. 1556, Sept. 16, 1937, p. 5; Matter of Franco Mining Corp., 1 SEC 285 (1936); Matter of Canusa Gold Mines, Ltd., Securities Act Release No. 1507, July 15, 1937 (even though explanatory notes accompany the balance sheet).

[203] Matter of Mutual Industrial Bankers, Inc., 1 SEC 268 (1936) (accounts receivable pledged to secure debt); Matter of Bankers Union Life Co., Securities Act Release No. 1278, Feb. 23, 1937 (stock pledged to protect bondholders).

[204] Matter of Mutual Industrial Bankers, Inc., 1 SEC 268 (1936).

[205] Matter of Lewis American Airways, Inc., 1 SEC 330 (1936). Whether comments preceding the balance sheet, but not referred to thereon, can be considered as modifying or explaining otherwise misleading items, the Commission left undecided. *Cf.* p. 31, *supra.*

[206] Matter of American Gyro Co., 1 SEC 83, 88 (1935).

[207] Securities Act Release No. 1448, May 20, 1937.

[208] Matter of American Gyro Co., 1 SEC 83 (1935).

or not they can appropriately be charged as a capital expenditure and carried as such upon successful completion, registrant must reveal that, due to imminent cancellation of its lease, such expenditure cannot be recovered through operations of its properties, and therefore must become a charge to the earned surplus account. Development expenditures should be amortized over the life of registrant's lease, if not charged to operations immediately. Indeed, the value of the lease itself should be amortized when there is no provision giving the lessee the right of renewal or extension.[209] To designate as "Patents," applications for patents, some of which have been abandoned, is misleading. Inclusion in "Experimental Expense" of a charge for depreciation of real estate not used in registrant's development work, gives an inadequate and misleading picture of the amount of work done by registrant on its inventions. By the same token, stock selling expenses should not be added into "Experimental Expense."[210] Indeed, distribution costs should be reflected on the balance sheet as an item separate from all other deferred charges.[211] Thus payments for services in preparing a new corporation's registration statement are properly carried under "Deferred Charges—Financing and Underwriting Expense."[212]

Credits

The liability side of the balance sheet has so far in the SEC cases been less susceptible to accounting legerdemain than credit items. But a few instances of distortion of liabilities appear. Where lease and option agreements contain no actual commitment to purchase, it is misleading to carry the full purchase price as a "Term Indebtedness" without the qualification that registrant could abandon the agreements without further obligation on its part.[213] It is false to show no current liabilities when in fact amounts are due to officers of registrant for services rendered to

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[209]Matter of Golden Conqueror Mines, Inc., Securities Act Release No. 1520, Aug. 6, 1937.

[210]Matter of Lewis American Airways, 1 SEC 330 (1936). But a division of overhead between "Experimental Expense" and "Stock Selling Expense" is not necessary for the purposes of the registration statement, though the Commission approves it as good cost accounting. *Id.* at 341.

[211]*Ibid.*

[212]Matter of Snow Point Mining Co., Inc., 1 SEC 311 (1936).

[213]Matter of Franco Mining Corp., 1 SEC 285 (1936). This case is unique in that it is the only one which presents the financial condition in a light less favorable than it actually is. The query naturally arises whether this would be held a "material" misstatement; *i.e.*, one which would tend to deter a prudent investor from buying registrant's securities, or one as to which an average prudent investor ought reasonably to be informed before buying. The distinction between these two definitions, as discussed in note 80, *supra*, is readily apparent here.

it,[214] or to shareholders because of the declaration by directors of a dividend.[215] When registrant issues "endowment bonds" payable at maturity partly in cash and partly in shares of registrant's stock, it is materially misleading for registrant to set forth its liability to pay cash and to ignore the obligation to deliver stock. It is a further defect to fail to indicate that the obligation to perform the latter arises prior to the maturity of the bonds. And when, in spite of its failure to express the obligation to pay stock, registrant deducts from its liabilities the amount of shares pledged for the discharge of the undisclosed obligation, registrant distorts its financial position.[216] The liability side of a financial statement is also defective when it fails to reflect a maximum contingent liability in respect to monies paid by the public for such stock as has been sold in violation of the Securities Act.[217]

Just as inflated property valuations may serve as a basis for the issuance of stock, they may be used to "build up" capital surplus, and this device has also been condemned by the Commission.[218] Gifts to registrant of money, mortgages, or of its own stock should be credited to a donated surplus account, and not confused or combined with earned surplus.[219]

The opinion has been expressed by the Chief Accountant of the Commission that when part of a company's plant has become obsolete or of lessened utility value, or of too high book value in comparison with replacement cost, a write-down from net cost values should not be charged to capital surplus. Such a reduction in valuation is simply a recognition, as of the date of the write-down, of an accumulation of depreciation in values incidental to the risks involved in the ordinary operation of the company's business. Since it would have been charged against income had it been discerned and provided for currently, the write-down itself should be charged to earned surplus. But the Chief Accountant further indicated that if a deficit is thereby created, it may be written off

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[214]Matter of National Invested Savings Corp., 1 SEC 825 (1936). Nowhere has the Commission defined current liabilities, but Rule 455 of General Rules & Regulations under the Securities Act states that "Funded debt . . . [has] reference only to an indebtedness having a maturity at the time of its creation of more than one year, independent of acceleration."

[215]Matter of Metropolitan Personal Loan Co., Securities Act Release No. 1594, Oct. 28, 1937.

[216]Matter of Bankers Union Life Co., Securities Act Release No. 1278, Feb. 23, 1937.

[217]Matter of Canusa Gold Mines, Ltd., Securities Act Release No. 1507, July 15, 1937.

[218]Matter of La Luz Mining Corp., 1 SEC 217 (1935).

[219]Matter of National Educators Mutual Ass'n, Inc., 1 SEC 208 (1935); Matter of General Income Shares, Inc., 1 SEC 110 (1935); Matter of Franco Mining Corp., 1 SEC 285 (1936). A "Reserve for Donated Stock" is at least equally acceptable.

against capital surplus, and that subsequent statements of earned surplus should designate the point of time from which the new surplus dates.[220]

The Income Statement

Although the profit and loss statement has so far figured less prominently in the SEC decisions than the balance sheet, of course in many instances deficiencies in the latter carry over to the income statement. The necessity of truthful presentation of facts is just as great, especially where the final figure is written into a general surplus account.[221] The Commission has ruled, in forcing a separation of earned and donated surplus, that including gifts as income in the profit and loss statement is improper.[222] Adding to income or to surplus the difference between the face amount and the cost of only partially collectible accounts is materially misleading when there is no indication in the accountant's certificate of the impropriety of this inflation. When finally writing off such debts as worthless, it is improper to charge them to the reserve for losses instead of to income or surplus as is necessary to correct the original improper entries.[223]

As for the handling of taxes on income, excess profits, and undistributed profits, the Chief Accountant has expressed the opinion that provision should be made for each, whether the period covered by the statement is a full year or only part thereof.[224] If the amount of the taxes which may be due cannot be determined with some degree of precision, this fact should be indicated and footnotes appended explaining such qualification. If it is impracticable or impossible to determine or accurately estimate the liability for surtax of undistributed profits, no provision for the tax need be made but the omission should be explained by footnote, indicating the approximate maximum amount involved. The surtax on undistributed profits should be shown in the profit and loss or income statement separately from other federal income taxes and if no such tax is incurred by the company, that fact should be indicated.

Exemptions[225]

Section 5 provides that, unless a registration statement is in effect as to a security, it shall be unlawful to use the mails or instru-

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[220]Accounting Release No. 1, April 1, 1937.

[221]*Cf.* Matter of Metropolitan Personal Loan Co., Securities Act Release No. 1594, Oct. 28, 1937.

[222]Matter of General Income Shares, Inc., 1 SEC 110 (1935).

[223]Matter of Metropolitan Personal Loan Co., Securities Act Release No. 1594, Oct. 28, 1937.

[224]Securities Act Release No. 1210, Jan. 6, 1937.

[225]See generally Throop and Lane, *Some Problems of Exemption under the Securities Act of 1933* (1937) 4 LAW AND CONTEMPORARY PROBLEMS 89; Legis.

mentalities of interstate commerce in order to sell such security. But Section 3 exempts a number of types of securities from the requirements of the Securities Act. In all, there are eleven broad classes enjoying this privilege. Subsection (b) of Section 3 confers on the Commission broad powers to exempt other issues when not in excess of $100,000. Pursuant to this authority, Regulations A and B have been promulgated, the latter dealing with the offering of certain oil and gas interests,[226] and the former with issues not over $100,000.

Section 4 provides for the exemption of certain transactions in unregistered securities, placing emphasis on the fact that the principal aim of the Securities Act is to regulate distribution as contrasted with trading.

Interpretation of the exempting provisions of the Securities Act has been accomplished in large part through opinions of the General Counsel.[227] But the exemption granted to intrastate issues has received careful and comprehensive treatment in a decision of the Commissioners themselves.[228] In *Matter of Brooklyn Manhattan Transit Corp.*[229] a New York corporation sold its entire bond issue to four New York banks without the use of the mails. Prior to completion of the resale undertaken by the banks, 15% of the issue was found to be in the hands of non-residents. The Commission held that to come within classification of "an issue sold only to persons resident within a single state," it is necessary that the securities at the time of completion of ultimate distribution shall be found only in the hands of resident investors. The issuer may not escape from the regulatory provisions of the Act by the simple device of making an original sale to a fellow resident, followed by an immediate interstate distribution by the latter.[230]

(1934) 34 COL. L. REV. 1348; Bumiller, *Exemption of Securities and Transactions under the Federal Securities Act of 1933* (1936) 10 U. CIN. L. REV. 125; Comments (1936) 45 YALE L. J. 1050 and 1076, 1085-94.

[226]Issuers of this class of securities are required to file an "Offering Sheet" of specified content and form before sales may be made to the public. The issuance of suspension orders under Rule 340 because of defective offering sheets began with the Commission's opinion in Matter of Alma and Skelly Johnson Farm, 1 SEC 784 (1936).

[227]See Compilation of Releases under the Securities Act of 1933.

[228]"Section 3(a). Except as hereinafter expressly provided the provisions of this title shall not apply to any of the following classes of securities: . . .
(11) Any security which is a part of an issue sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such State or Territory."

[229]1 SEC 147 (1935). See also the excellent restatement of this topic in the Opinion of the General Counsel, Securities Act Release No. 1459, May 29, 1937.

[230]Since the Act is concerned with the problem of distribution as distinguished from trading, to allow such a device would be to ignore the mechanics

The sales of an issue which are to be taken into account to determine whether the issue is sold only to residents are the sales in connection with distribution. The exemption does not apply merely to the original sales by the issuer. Nor does it apply to every sale from the date of issuance till maturity. The point at which distribution to the public is complete is a question of fact to be determined in the light of all the circumstances of the offering.

The Commission in discussing the meaning of an "instrument of . . . communication in interstate commerce" in Section 5(a) (1) indicated that a dealer who, acting for his own account, offers unregistered bonds for sale to a broker in another state by long distance telephone may be in violation of the Act. The Commission also pointed out that one who delivers unregistered securities to a local bank, draft attached, for delivery to the purchaser outside of the state, *causes* the securities to be carried in interstate commerce for the purpose of sale in violation of Section 5(a) (2). And the purchaser who authorizes his broker to use the mails for the purpose of delivery to him, also causes the securities to be carried through the mails after sale in "possible" violation of Section 5 (a) (2).[231]

"Where sales are made to brokerage houses [or banks], sellers must reasonably anticipate that they are dealing with agents and that the latter may use the mails for purposes of delivery to their customers. It is immaterial to the issue of causation that the identity of the principals is unknown to the sellers. It is also immaterial whether the agent uses the mails to deliver to an interstate or intrastate address, since the Act prohibits the use of the mails regardless of geographical boundaries."[232] Sellers in such instances are held to have, at least indirectly, "caused" the use of the mails by their sales to agents who delivered by mail to the purchasers.

Whether mailing of securities to a purchaser by his broker is "for delivery after sale" within the meaning of Section 5(a) (2) or whether "delivery after sale" is completed when made to the broker is to be decided on the merits of each case. The consideration of surrounding facts and circumstances is not precluded by legal technicalities of agency or other relationships. Where sellers have delivered to brokers, the controlling factor would seem to be whether the agent's authority is restricted to the purchase of securities for, and their prompt delivery to the principals. "If the

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of distributing securities and to nullify the purpose of Congress. See H. R. REP. No. 85, 73d Cong., 1st Sess. (1933) 15-16.

[231]Matter of Brooklyn Manhattan Transit Corp., 1 SEC 147, 169 (1935).

[232]*Ibid.*

agents are authorized to, and in fact do hold the securities as depositaries, so that the securities actually come to rest, it may be conceded that delivery after sale has been completed. In such case the seller is not to be held liable for a violation of the Act, even though the mails[233] . . . are at some later date used to carry the securities to the principal. The seller may in such case have 'caused' such delivery, but it does not constitute a delivery 'after sale' within the meaning of the Act.

"On the other hand, when in fact the agent is merely a conduit of title and possession, . . . when the securities have not come to rest, delivery after sale has not been completed, and if the mails . . . are used . . . the [seller] has violated the Act."[234]

"Broker's transactions, executed upon customers' orders . . . but not the solicitation of such orders" are exempted from the provisions of Section 5 by Section 4(2).[235] The Commission ruled that these words embrace both the act of solicitation and the subsequent steps taken to complete the sale or delivery after sale. Thus, though a broker solicits an order without using the mails, he is nevertheless subject to the provisions of Section 5 if he uses interstate facilities in connection with the delivery of the securities.

A national securities exchange may, in the Commission's opinion, because of the intimate and unbroken relationship of transactions on such exchange to the interstate "flow" of securities through such exchange in itself be regarded as a means or instrument of communication or transportation in interstate commerce. Therefore at least those sales of non-exempt unregistered securities over the stock exchange made by dealers subject to Section 5 which are part of such "flow" may violate the provisions of Section 5 (a) (1).[236]

Section 4(1) exempts "transactions by an issuer not involving any public offering." In *Matter of Henry Friedlander,* etc.,[237] the Commission held that an offering to approximately three hundred and fifty stockholders was not within the exemption. The holding followed the interpretation of this section promulgated in an opinion of the General Counsel[238] in which he discussed in detail the various factors which should be considered in determining whether, as a matter of fact, any particular transaction involves a

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[233]"Mails" is used hereinafter alone as a condensation of "Mails or instruments of transportation or communication in interstate commerce."

[234]Matter of Brooklyn Manhattan Transit Corp., 1 SEC 147, 170-1 (1935).

[235]See Securities Act Release No. 1256, Feb. 9, 1937.

[236]See Matter of Brooklyn Manhattan Transit Corp., 1 SEC 147, 173 (1935). *Cf.* Section 2 of the Exchange Act.

[237]Exchange Act Release No. 1305, July 16, 1937.

[238]Securities Act Release No. 285, Jan. 24, 1935. *Cf.* Securities Act Release No. 97, Dec. 28, 1933.

public offering. It was there pointed out that consideration must be given to (1) the number of offerees and their relationship to each other and to the offeror, (2) the number of units offered, (3) the size of the offering, and (4) the manner of the offering. Even though the offering is restricted to a particular group or class, it may nevertheless be a public offering if it is open to a sufficient number of persons. In the *Friedlander* case, considerable reliance was placed on the legislative history of this exemption, particularly on the statement in the *Report of the Conference Committee*[239] that "Sales of stock to stockholders become subject to the Act unless the stockholders are so small in number that the sale to them does not constitute a 'public offering'."

THE SECURITIES EXCHANGE ACT OF 1934[240]

The career of a security after it has been launched in life under the eye of its companion statute is the principal concern of the Exchange Act.[241] Trading, as distinguished from distribution, is the activity which it is designed to regulate.[242] An early commentator on the Act wrote that "since Congress has left so much to the Commission, the Securities Exchange Act is for many purposes still unwritten. Its formulation rests with the five Commissioners. They and not Congress will ultimately define the law."[243] It is therefore necessary to examine the formal opinions of the Commission to see how it has interpreted the statute.

Registration and Trading Privileges

Subsection (e) of Section 12 of the Exchange Act gave the Commission power to permit securities listed on any exchange at

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[239]H. R. REP. No. 152, 73d Cong., 1st Sess. (1933) 25. For a very complete study in support of the Commission's holding, see Brief for Appellant, SEC v. Sunbeam Gold Mines Co., C. C. A. 9th, No. 8637. The crux of the problem would seem to be whether the prospective buyers are in some especially privileged position which renders it unnecessary that they be protected by the registration and prospectus requirements of the Act. If no protection is needed, the offering might be exempt. If protection is necessary, the offering should be held to be "public."

[240]48 STAT. 881 (1933) 15 U. S. C. A. 78 (Supp. 1936). See generally Gates, *The National Securities Exchange Act of 1934* (1934) 39 COMM. L. J. 227; Tracy and MacChesney, *The Securities Exchange Act of 1934* (1934) 32 MICH L. REV. 1025; Seligman, *Problems under the Securities Exchange Act* (1934) 21 VA. L. REV. 1; Hanna and Turlington, *Protection of the Public under the Securities Exchange Act* (1935) 21 VA. L. REV. 251. The constitutionality of the Exchange Act was upheld in SEC v. Torr, 15 F. Supp. 144 (S. D. N. Y. 1936) *rev'd. on other grounds*, 87 F. (2d) 446 (C. C. A. 2d, 1937). *Cf.* Martin, *Constitutionality of the Securities Exchange Act of 1934* (1935) 21 A. B. A. J. 811.

[241]Of course securities issued prior to the enactment of the Securities Act are also subject to the provisions of the Exchange Act.

[242]See in Section 2 the declaration of necessity for regulation of trading.

[243]Lippman, *The Securities Exchange Act* (1935) 69 U. S. L. REV. 18, 33. Authority to promulgate rules and regulations under the Exchange Act is conferred by Section 23.

the time of the latter's registration, to be registered until July 1, 1935 without complying with the other provisions of Section 12 for permanent registration. Pursuant to this authority, the Commission promulgated a series of rules[244] which have, of course, since been repealed because of expiration of the time limit imposed. But decisions made under this subsection have more than a historical interest.

The Commission held that as to this class of temporarily registered securities, it has the right either to grant or deny an exchange's application for delisting them.[245] But in deciding whether or not to delist the security, the Commission must take into account not only the facts of the case presented and the public interest, but the protection of investors in the particular security as well.[246] In spite of abuse of their powers by "insiders"[247] the Commission will not delist a corporation's securities where remedial action has been taken, although belated, since delisting would subject the shareholders' interest to undue risk.[248]

Of particular significance for their broader implications have been certain pronouncements by the Commission under this subsection as to its rule making power. It conceded that it could not formulate regulations in an arbitrary and discriminatory manner, but that it must confine discretion within recognized traditional limits.[249] The Commission, however, considered it a proper exercise of discretion within the standards prescribed by Section 12(e) to adopt Rule JE7 denying or revoking temporary registration on a national exchange to any security neither registered nor exempt from registration under the Securities Act of 1933.[250] This rule, the Commission found, had a factual foundation and created a reasonable classification of securities, because trading on the New

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[244]Rules & Regulations under the Securities Exchange Act, Series JE, repealed by Exchange Act Release No. 990, Dec. 21, 1936.

[245]Rule JE6 so provided.

[246]Matter of Hupp Motor Car Corp., 1 SEC 177 (1935).

[247]See *id.* at 181 for indication that the Commission will not attempt to appraise the reasonableness of insiders' salaries despite the failing condition of the company. "In the absence of bad faith it is primarily the business of the management and of stockholders."

[248]But such denial was made without prejudice to the petitioning exchange's rights as to delisting in respect of permanent registration of the security.

[249]See Note (1936) 36 COL. L. REV. 974.

[250]Matter of Brooklyn Manhattan Transit Corp., 1 SEC 147 (1935). Again the Commission pointed out whether it could exercise similar power to refuse registration upon a national exchange under Section 12(b) and (c) was not determined.

York Stock Exchange in a security neither exempted nor registered would in all probability result in violations of the Securities Act.[251]

The withdrawal of permanently registered securities from listing and registration is a matter of more continuing importance. Where an issuer failed to comply with the provisions of Section 12(b) by not filing an independent public accountant's certificate stating the latter's opinion of the issuer's profit and loss statement and of the accounting principles followed, and violated Section 13 by not filing its annual report, the Commission withdrew the company's registration.[252]

Several cases have dealt with an application for withdrawal by the issuer itself. In spite of the protests of the exchange, the Commission held that it has no power to deny the application even if it believes that trading on the particular exchange should be continued. Its authority relates only to insisting upon certain disclosures as a condition of the securities acquiring and retaining a listed and registered status. But the Commission may impose conditions necessary for the protection of security holders against abrupt action by the issuer who seeks termination of listed trading privileges,[253] and the burden is on the applicant to present facts upon which the Commission can determine whether it will be necessary to impose any such conditions in granting the application. Failure to meet this burden has resulted in a denial of the application to withdraw.[254] But when the application is unopposed, and evidence is offered that the procedure followed is in accordance with the rules of the exchange from which the issue is to be stricken, withdrawal has been approved by the Commission.[255]

A national securities exchange, upon application to and approval of such application by the Commission may extend unlisted trading privileges to any security duly listed and registered on any other national securities exchange. Such privileges are granted and terminated pursuant to Section 12(f) which received its cur-

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[251]"Not only may sales by dealers . . . be making use of an instrument of communication or transportation in interstate commerce . . . but it is a recognized fact, of which notice may be taken without positive evidence, that a person selling over the stock exchange cannot in any way control the sale in order to prevent [an extrastate] purchaser . . . from purchasing the securities offered and thereafter requiring their delivery in interstate commerce after the sale." Matter of Brooklyn Manhattan Transit Corp., 1 SEC 147, 173 (1935).

[252]Matter of Dolphin Paint & Varnish Co., 1 SEC 879 (1936).

[253]In Matter of Allan Industries, Inc., Exchange Act Release No. 1027, Jan. 22, 1937, the Commission ordered a week's grace before the delisting would be complete.

[254]Matter of Teck-Hughes Gold Mines, *etc.*, Exchange Act Release No. 1261, June 21, 1937.

[255]Matter of North American Securities Co., *etc.*, Exchange Act Release No. 1292, July 8, 1937.

rent form by amendment approved May 27, 1936.[256] As a condition of extension, the applicant must establish that there exists in the vicinity of the exchange in question sufficiently widespread public distribution of the security, and sufficient trading on the exchange, to render the extension of unlisted trading privileges "necessary or appropriate in the public interest or for the protection of investors." In order to apply these standards, the Commission need not find that either the exchange or the over-the-counter market serves the investor better. Congress simply sought to give the means whereby adequate and fair competition should prevail between the two markets in order to allow each to develop in accordance with "its natural genius and consistently with the public interest."[257] If an exchange seeks to establish an independent market in a security, it must show the existence of sufficient public distribution thereof and sufficient public trading activity therein in the vicinity of the exchange to give assurance that a market on the exchange will be a *true* market—not necessarily the *best* market, but a real market, entitled to enter into fair and open competition with other *bona fide* markets.[258]

In determining adequacy of distribution and trading, emphasis has been shifted to the question whether a sufficient number of investors are affected to make convenience and economy for them in trading a matter of public concern, and to a consideration of the importance of the trading sought to the existence or the efficiency of the applicant exchange. Thus the fact that commissions and odd-lot differentials are no higher, or even lower on the applicant exchange than on primary exchanges supports the applicant's case.[259] On the other hand the contention of the issuer, in oppos-

[256]Public L. No. 621, 74th Cong., 2d Sess. (May 27, 1936). Unlisted trading privileges pursuant to Section 12 (f) (1) embody no requirement of full and continuing information concerning the securities and issuers thereof. It provides for the "continuation" in contradistinction to "extension" as provided for in Section 12 (f) (2). It was designed to avoid any dislocation which might follow an abrupt termination of these privileges, and to make possible a gradual and orderly adjustment of the peculiar problems presented by them. Thus where an application to *continue* unlisted trading privileges had never been filed by an exchange and no trading in the issue had taken place since Oct. 1, 1934 (when Section 12(a) providing for permanent registration became effective), an application pursuant to Section 12(f) (1), filed as late as November, 1936, was denied on the ground that it was not in the public interest or for the protection of investors to *continue* unlisted trading privileges after so extended a hiatus in trading. Matter of Applications of Boston Stock Exchange, *etc.*, Exchange Act Release No. 1298, July 14, 1937. It is not material that the exchange unfortunately designated the wrong security in a timely application. The fact remains that an application for the continuation of unlisted trading privileges was never filed with respect to the issue now being proposed. *Ibid.*

[257]Matter of Edison Electric Illuminating Co. of Boston, 1 SEC 909 (1936).

[258]Matter of Applications by the Pittsburgh Stock Exchange, *etc.*, Exchange Act Release No. 1139, April 14, 1937.

[259]*Ibid.*

ing the extension of unlisted trading privileges, that the minimum cost of doing business over-the-counter is less than on the exchange is without force because the same may be true as to any listed security. And the fear of unusual depression or enhancement of prices on the exchange by the entry of large sell or buy orders at the market is not valid because of the practical checks against such operations. Moreover the objection is weak because it is equally applicable to any other listed security.[260] That mailing and insurance charges will be saved and that the customer will receive a more prompt report of execution of odd-lot orders, if the order is executed on the applicant exchange, are facts which favor granting of unlisted trading privileges. The fact that the applicant exchange could not survive if restricted to trading in listed securities and the possibility of expansion in unlisted trading to avoid operating losses are matters of public interest. The existence of adequate local exchange facilities for local issues is considered to be desirable, especially when the community has enjoyed such facilities for many years. Though savings which accrue to the customer from absorption of a tax by the odd-lot dealer may have a bearing upon considerations of "public interest" and "protection of investors," the fact that odd-lot transactions on the applicant exchange might involve a lower net tax charge to the purchaser because of variations in different tax laws cannot be classed as such a consideration.[261]

When the bulk of the trading in a particular bond is over-the-counter and the bond market on the applicant exchange is no better in its quotations than the local over-the-counter market, and when bond trading is a relatively unimportant part of the exchange's business, extension of unlisted trading privileges has been held to be not in the public interest even if sufficient public distribution and trading exist. "Only the existence of exceptional circumstances could warrant a finding" to the contrary.[262] In determining whether there is sufficient public trading activity to satisfy the purposes of Section 12(f) the Commission has held it within the scope of its duty to decide not only whether sufficient trading existed at the time of the application, but also whether proper activity would continue after the admittance of the security to unlisted trading on the applicant exchange.[263]

The Commission has interpreted the statute to authorize the granting of unlisted trading privileges in a security in odd-lots and

[260]Matter of Edison Electric Illuminating Co. of Boston, 1 SEC 909 (1936).

[261]Matter of Applications by the Pittsburgh Stock Exchange, *etc.*, Exchange Act Release No. 1139, April 14, 1937; Matter of Applications by the Boston Stock Exchange, *etc.*, Exchange Act Release No. 1298, July 14, 1937.

[262]Matter of Applications of the Pittsburgh Stock Exchange, *etc.*, Exchange Act Release No. 1139, April 14, 1937, p. 6.

[263]Matter of Edison Electric Illuminating Co. of Boston, 1 SEC 909 (1936).

a denial of those privileges in the same security in round lots.[264] But the practice has been to deny round-lot privileges without prejudice to applications which may be later made in connection with any attempt by the applicant exchange to establish a *bona fide* independent round-lot market in the securities.

As for the termination of unlisted trading privileges, Section 12(f) imposes the condition that the Commission find that by reason of inadequate public distribution or trading, or because of the character of trading, termination is appropriate in the public interest. Where the inadequacy of trading activity is not such as to convince the Commission that it is appropriate in the public interest to terminate unlisted trading privileges, the application must be denied. It is not enough to demonstrate that the unlisted exchange market is less active than the over-the-counter market.[265] Mere inadequacy alone is not enough. It must be shown that undesirable consequences flow from this circumstance.[266] Actual loss to investors is not necessary; potential harm may be a sufficient basis for termination. Thus where the exchange quotations did not reflect within appropriate limits the price of a stock over-the-counter, the Commission held that the continuance of unlisted trading privileges was not justified. Under such circumstances the exchange did not furnish a proper focal point for trading in the particular securities and therefore the Commission ordered a termination.[267] When an exchange specialist participated in all odd-lot transactions and in about one-half of all round-lot transactions over a certain period, the Commission held that the market on that exchange was primarily a private dealer's market, maintained by the specialist in competition with the private markets made by over-the-counter dealers, and did not constitute "public trading" within the meaning of Section 12(f). This situation was deemed to justify the discontinuance of unlisted trading privileges on the exchange.[268]

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[264]Matter of Applications of the Pittsburgh Stock Exchange, *etc.*, Exchange Act Release No. 1139, April 14, 1937 (Healy and Douglas, Commissioners, doubting); Matter of Applications by the Boston Stock Exchange, *etc.*, Exchange Act Release No. 1298, July 14, 1937.

[265]Matter of American District Telegraph Co., *etc.*, Exchange Act Release No. 1283, July 2, 1937.

[266]Matter of City & Suburban Homes Co., Exchange Act Release No. 1012, Jan. 8, 1937.

[267]On the same day the quotation over-the-counter was 53; on the New York Curb, 35 or 40. Matter of Piedmont & Northern Ry. Co., 1 SEC 916 (1936). "Continuance of unlisted trading privileges . . . does not possess the affirmative public value that attends the continuance of listed trading privileges." *Id.* at 5.

[268]Matter of American District Telegraph Co., *etc.*, Exchange Act Release No. 1283, July 2, 1937. See "SEC, Report on Trading in Unlisted Securities Upon Exchanges," p. 11.

With respect to the requirement of inadequate public distribution, the Commission has held that, where only 3% of the total shareholders, holding about 2.7% of the entire issue, are located in the territory surrounding the exchange, the condition for termination is satisfied. An order has been granted even though the issuer's motive in pressing its application was to avoid restrictions imposed on it as a registered bank by the Federal Reserve Board.[269]

Brokers and Dealers

The registration of brokers and dealers is governed by the provisions of Section 15, as amended.[270] The Commission is ordered to deny or revoke registration of a broker or dealer only "after appropriate notice and opportunity for hearing."[271] Several cases have dealt with the problem of what constitutes sufficient notice. Where an applicant has been given due notice and fails to appear, the hearing will proceed before a trial examiner although the applicant is not present or represented.[272] Notice is sufficient when sent by registered mail and when delivery to the party is established by a post office return receipt.[273] But when the Commission is unable to effect personal service on a registrant it will not permanently revoke his registration, but will merely order suspension pending final disposition of his case. The Commission will give consideration to the lifting of the suspension order or to imposing permanent revocation if and when the registrant appears to be heard or personal service can be effected.[274] When a registration is merely suspended, the Commission need not make findings on all the material misstatements indicated in the record.[275]

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[269]Matter of Security-First National Bank of Los Angeles, 1 SEC 923 (1936). But since notice of the proceeding had not been given to applicant's stockholders, the Commission deferred the effectiveness of its order to enable them to voice objections to termination of unlisted trading privileges on the particular exchange.

[270]Public L., No. 621, 74th Cong. 2d Sess. (May 27, 1936). This amendment is, in substance, Congressional enactment of the old MA series of Rules promulgated by the Commission under the Exchange Act. It would seem, therefore, the decisions under these Rules may be relied upon to indicate how the Commission will interpret the current Section 15. The MA series was repealed by Exchange Act Release No. 721, June 6, 1936.

[271]Exchange Act, Section 15(b). The condition is also annexed that the Commission find such action to be in the public interest.

[272]Matter of Industrial Engineering Co., 1 SEC 486 (1936).

[273]Matter of Venner, 1 SEC 459 (1936).

[274]Matter of Owens, 1 SEC 416 (1936); Matter of Donald Montague & Co., 1 SEC 463 (1936); Matter of H. Owen Jones, *etc.*, Exchange Act Release No. 1226, May 27, 1937. This careful courtesy is no longer of any importance because the form of the registration statement has been changed to exact from the registrant his "consent" that "notice of any proceeding before the Commission in connection with . . . registration . . . may be given by sending such notice by registered mail or confirmed telegram to the person named below, at the address given." Matter of Parsons, Exchange Act Release No. 1152, April 17, 1937.

[275]Matter of Venner, 1 SEC 459 (1936).

The presence of extenuating circumstances has led the Commission to hold that it would entertain an application from a broker whose registration had been revoked, if filed subsequent to six months after the revocation.[276] The explanation that applicant hurriedly signed his application for registration, which was prepared by his attorney, without examining the answers will not be accepted in extenuation of false statements therein. "Acceptance of such an explanation would effectively relieve all applicants of the responsibility of reading their applications, and the representation by an applicant that 'all statements and representations herein are true to the best of registrant's knowledge and belief' would be meaningless."[277]

One of the grounds for denial of registration is the willful making of a material misstatement in the application.[278] Willful failure to disclose material facts has been held to justify a refusal.[279] And registrant's business and residence addresses are considered material facts which must be correctly stated.[280] Another ground for revocation of a registration is the disregard of any of the Commission's rules.[281] Deliberate failure of an applicant to comply with the registration requirements for thirteen months after he was advised by the Commission of the necessity for registration has been the basis for denial of his belated application.[282] Rule MB2 provides that supplemental reports must be filed setting forth material events which occur subsequent to the filing of the registration statement.[283] Consequently a broker's failure to notify the Commission of a change in his business address[284] or that of the person designated to receive notices on his behalf[285] has been held to constitute the concealment of a material fact and a basis for suspension or revocation. Registrant's failure to report that he had been denied a license under a state Blue Sky Law is sufficient ground for revocation.[286]

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[276]Matter of Louis Grow, Exchange Act Release No. 1210, May 20, 1937 (false statement not willful).

[277]Matter of Securities Exchange Corp., Exchange Act Release No. 1395, Sept. 23, 1937, p. 2.

[278]Exchange Act, Section 15(b)(1)(A).

[279]Matter of Industrial Engineering Co., 1 SEC 486 (1936); Matter of B. W. Sargent, *etc.*, Exchange Act Release No. 1209, May 20, 1937.

[280]Matter of Dufief, 1 SEC 237 (1935); Matter of Chapman, 1 SEC 262 (1935).

[281]Exchange Act, Section 15(b)(1)(D).

[282]Matter of L. P. Atwater & Co., Exchange Act Release No. 1392, Sept. 21, 1937 ("without prejudice to any new application filed after Dec. 31, 1937").

[283]*Cf.* Matter of Owens, 1 SEC 417 (1936) (decided under former MA Rule).

[284]Matter of Venner, 1 SEC 459 (1936); Matter of H. Owen Jones, *etc.*, Exchange Act Release No. 1226, May 27, 1937.

[285]Matter of Donald Montague & Co., 1 SEC 463 (1936).

[286]Matter of Sargent, Exchange Act Release No. 1209, May 20, 1937.

A third ground for denial or revocation is the existence of an injunction issued by any court of competent jurisdiction against the registrant forbidding him to engage in certain practices in connection with securities dealings.[287] Even though a broker consents to an injunction "without admitting fraud," he is nevertheless subject to the revocation provisions of the Act.[288] The fact that a corporation is enjoined is sufficient ground for the denial of registration to a broker individually when he owned and operated the enjoined corporation.[289] But where the injunction is not in existence at the time the registration statement is filed, the Commission has no power to deny registration.[290] An injunction issued, however, after the application affords adequate ground for revocation of the effective statement.[291] Where the Commission has refused registration because at the time of filing the applicant was temporarily enjoined, it is at liberty to consider later any subsequent disposition of the injunction suit.[292] And the Commission may reverse its order after the court has vacated the injunction and dismissed the case as to the registrant.[293]

Registration may be denied if the applicant has been convicted within ten years of any crime involving the purchase or sale of securities.[294] But if conviction is for a crime not involving the purchase or sale of securities there is no basis for the denial of registration.[295] The fact that registrant has made restitution to the prosecuting witness and that his conviction has been placed on file without imposition of sentence does not prevent his offense from being within the provisions of the statute.[296] Facts of a registrant's past far less derogatory of character than criminal conviction may also serve as a basis for denial. Information of a broker's past activities, as well as its form of organization and connections,

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[287]Exchange Act, Section 15(b)(1)(C). Matter of Howard M. Roberts Co., 1 SEC 263 (1935); Matter of Wilson, 1 SEC 402 (1936).

[288]Matter of Jacobs, *etc.*, Exchange Act Release No. 1381, Sept. 15, 1937.

[289]See Matter of Hamlin, Exchange Act Release No. 1300, July 14, 1937. "The acts of the corporation could have been the acts of no one but Hamlin. That a corporate form was the defendant . . . is merely a legal incident." *Id.* at 4.

[290]Matter of Industrial Engineering Co., 1 SEC 486 (1936). This case was decided under old Rule MA4, which contained the words "enjoined on the date of the filing of such registration statement." Section 15 as amended omits this language but uses the present tense ("is enjoined") so that the same result would seem to follow under either wording. The tense of the verb is important only in the case of an applicant who has been but is no longer enjoined at the time of application.

[291]Matter of Owens, 1 SEC 416 (1936).

[292]Matter of Wilson, 1 SEC 402 (1936).

[293]Matter of Wilson, Petitioner, 1 SEC 502 (1936).

[294]Exchange Act, Section 15(b)(1)(B). Matter of Hughes, 1 SEC 843 (1936); Matter of Natanson, 1 SEC 852 (1936).

[295]Matter of Sargent, Exchange Act Release No. 1209, May 20, 1937.

[296]Matter of Louis Grow, Exchange Act Release No. 1210, May 20, 1937.

must be furnished to the Commission to enable it to determine whether it is in the public interest that the applicant shall be granted or denied the privilege of using the mails and channels of interstate commerce in making a market for securities.[297] The Commission gives considerable weight to a registrant's past conduct. Thus, where witnesses testified that various misrepresentations had been made to them by a broker in selling them securities, and that the broker had repeated extravagant statements made in a brochure to prospective purchasers, the Commission refused registration. Warning prospective buyers that stock is offered as a speculation does not confer unbridled license upon the selling broker. Nor does the fact that flamboyant sales data manages to get by postal authorities mean that it is sufficiently accurate for use in selling securities. The repetition of such statements is not justified unless their truth is supported by an independent check by the broker.[298]

Manipulation

Respondents charged with manipulation of securities[299] and against whom the Commission is proceeding with a view to suspension or expulsion from their exchange memberships[300] have resisted with demands for details of the offenses charged. The Commission has answered that its counsel need not furnish a bill of particulars which includes the evidence intended to be produced.[301] Notice, the Commission has contended, under the requirements of the Exchange Act (and under the requirements of due process) is satisfied if the person alleged to have acted in violation of a statute is duly informed of the nature of the charge in order that he may have ample opportunity to present an appropriate defense. The Commission has pointed out that its customary notice, order to show cause, and bill of particulars, by following the language of the statute which describes the nature of the offense, meet even the strict common law requirements governing the sufficiency of indictments.[302] Moreover, the inherent flexibility of

[297]Matter of Industrial Engineering Co., 1 SEC 486 (1936). "The creation of a market" was the crux of the old Section 15. This has been broadened in the new Section 15 to the "effecting of any transaction, or the inducing of purchase or sale of, any security . . ."

[298]Matter of Wilson, 1 SEC 402 (1936).

[299]Exchange Act, Section 9(a)(1) and (2); SEC v. Otis Co., 2 PRENTICE-HALL SECURITIES REGULATION SERV., par. 12306 (N. D. Ohio 1936) (injunction denied). See generally Moore and Wiseman, *Market Manipulation and the Exchange Act* (1934) 2 U. OF CHI. L. REV. 46; Mathias, *Manipulative Practices and the Securities Exchange Act* (1936) 3 U. OF PITTSBURGH L. REV. 7, 104; Comment (1937) 46 YALE L. J. 624.

[300]Exchange Act, Section 19(a)(3).

[301]Matter of Meehan, 1 SEC 238 (1935); Matter of Wright, 1 SEC 482 (1936).

[302]*Cf.* Potter v. United States, 155 U. S. 438, 39 L. ed. 214 (1894).

administrative procedure makes for less strictness in insistence upon technicalities, if the substantial elements of notice and hearing are met.[303] Hearings before examiners can always be adjourned and witnesses recalled so that respondents will not unjustifiably be surprised by such evidence as may be presented.[304]

Though respondents have no legal right to obtain details in advance of the hearing, the Commission, in its discretion, may comply with a request in order to expedite the proceedings. But this is done with the understanding that any statement of matters furnished shall not have the effect of limiting counsel for the Commission from introducing additional evidence at the hearing.[305] Another matter wholly within the discretion of the Commission is the choice and change of venue. In the *Meehan* case respondent's motion for a change of venue was denied. "The Commission originally designated Washington, D. C. as the place of hearing upon the theory that this case, being of importance in that it was one of the first cases to be brought under the provision of the statute [Section 19(a)(3)], should be subject to the Commission's own close supervision at all stages. Although the Commission, in accordance with its usual practice, designated a trial examiner to take the testimony, it was hoped that members of the Commission would themselves sit even at this stage so far as the press of other business might permit."[306]

The later of the two *Meehan* cases[307] is particularly valuable for its definition of manipulative practices proscribed by Section 9(a)(1) and (2). Respondent's violation of the Act was considered to be of such seriousness that the Commission imposed the greater penalty of expulsion rather than mere suspension for not more than one year.[308] The contention that respondent's activities were not interstate was rejected with the observation that national securities exchanges are "modern mechanisms for the rapid transfer of ownership in securities [which] cannot conceivably operate without employing ganglion-like their vast net-work of wire communications that cover the country."[309]

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[303] *Cf.* Cincinnati, H. & D. Ry. Co. v. I. C. C., 206 U. S. 141, 51 L. ed. 995 (1907).

[304] Considerations of this character have induced the Federal Trade Commission not to grant requests for bills of particulars. See (1918) FED. TR. COM. REP., 54.

[305] Matter of Wright, 1 SEC 482 (1936).

[306] Matter of Meehan, 1 SEC 238, 241 (1935).

[307] Exchange Act Release No. 1331, Aug. 2, 1937. See also Exchange Act Release No. 1330, Aug. 4, 1937, announcing the adoption of rules "defining practices which are manipulative, deceptive or fraudulent in the over-the-counter markets."

[308] See Section 19 (a) (3).

[309] Matter of Meehan, Exchange Act Release No. 1331, Aug. 2, 1937, p. 37 [citing Stafford v. Wallace, 258 U. S. 495, 66 L. ed. 735 (1921)].

The respondent was found to have been active in bringing new buying power into the market, encouraging his friends to buy, and inducing persons in the brokerage business to recommend the particular stock to their customers. His associates traded heavily on narrow price fluctuations. When weakness in the stock developed, the market was banked by heavy scale buy orders placed sometimes directly by respondent for his firm, at other times for his wife, who was held to be his *alter ego*[310] and occasionally by associates. Further evidence from which the Commission inferred a strong incentive to manipulation was an agreement by underwriters to take the stock at a price in excess of its book value in a corporation whose earnings for a number of years had shown a large deficit. Moreover the take-down price was above the market, and an agreement was made with the largest shareholder to immobilize his holdings for several months. Respondent was under contract to accept a large block of the securities and the Commission found that his purpose was to maintain its price at a level sufficiently high for him to unload his large holdings at no loss.

Section 9(a) (1)[311] in substance forbids the matching of orders for the purpose of creating a misleading appearance of active trading. The Commission has pointed out that the mere "crossing of orders is, of itself, not illegal." Where a broker has both an order to buy and an order to sell at the same price, the transaction can be consummated by the crossing of these orders in accordance with the protective provisions of the exchange rules. Also, a broker who receives an order to buy may himself supply the stock to the customer, provided that he gets his customer's assent to act as principal and not as broker in the transaction. Such conduct in and of

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[310] "Mrs. Meehan, throughout the period covered by this proceeding, was clearly simply the *alter ego* of the respondent. No distinctions can thus be made between her actions and respondent's actions, her ownership and respondent's ownership." Matter of Meehan, Exchange Act Release No. 1331, Aug. 2, 1937, p. 11.

[311] "Section 9. (a) It shall be unlawful for any person, directly or indirectly, by the use of the mails or any means or instrumentality of interstate commerce, or of any facility of any national securities exchange, or for any member of a national securities exchange—

(1) For the purpose of creating a false or misleading appearance of active trading in any security registered on a national securities exchange, or a false or misleading appearance with respect to the market for any such security, (A) to effect any transaction in such security which involves no change in the beneficial ownership thereof, or (B) to enter an order or orders for the purchase of such security with the knowledge that an order or orders of substantially the same size, at substantially the same time, and at substantially the same price, for the sale of any such security, has been or will be entered by or for the same or different parties, or (C) to enter any order or orders for the sale of any such security with the knowledge that an order or orders of substantially the same size, at substantially the same time, and at substantially the same price, for the purchase of such security, has been or will be entered by or for the same or different parties."

itself is not violative of the provisions against matching orders. But where respondent actually initiates a buy order and sends it with a corresponding sell order for a discretionary account, he is in substance using the mechanism of the exchange to transfer a block of shares from his account to another over which he has discretionary authority, and is guilty of matching.

Before matching of an order placed by a third person can be established, it is necessary to attribute to respondent knowledge of that order and knowledge that it would be met by an order which respondent himself had given. The fact that respondent knows that a third person contemplates purchasing some stock and that if the order were placed at around the market, it would in all probability meet respondent's own sell orders, is not sufficient to establish matching within Section 9(a)(1). Respondent is under no duty to dissuade such purchaser from buying the stock, nor is he under a duty to disclose that he is selling.

When evidence shows only a "bulling" of a particular issue by respondent and a subsequent purchase by a third party, it is not sufficient to constitute illegal matching. But an unexecuted sell order can be deemed to be a continuing offer to sell, and if respondent knows that, as a result of his urging, a third person has placed a buy order which will in all probability be met by respondent's unexecuted sell order, there is illegal matching if respondent's purpose is that prohibited by Section 9(a)(1). The fact that orders are matched at the low of the day is not proof against possession of an illegal purpose by respondent. It may well be explained as designed to indicate strong support for the market as it shades away slightly from the highs. In the *Meehan* case, the Commission found the conclusion "irresistible . . . that respondent's purpose was . . . to create a misleading appearance of active trading."[312]

Section 9(a)(2) provides that it shall be unlawful "to effect, alone or with one or more other persons, a series of transactions in any security registered on a national securities exchange creating actual or apparent active trading in such security or raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such security by others." To justify the inference that purchases are in violation of this section, the purchases must be traceable to the one charged with manipulation and he must have possessed the design to raise the price for the specified statutory purpose of inducing the purchase of the stock by others. The placing of buy orders with the purpose of supporting a price in the hope that the stock might steady at a particular figure is not

[312]Matter of Meehan, Exchange Act Release No. 1331, Aug. 2, 1937, p. 16.

proscribed by the Exchange Act. Nor is the placing of sell orders substantially above the market in an effort to stabilize the price, or in the hope that some stock could be unloaded at the high mark, a violation of the Act.

The fact that purchases resulted from intimations received from persons close to respondent that the latter was interested in a particular corporation is not sufficient, unless evidence substantiates the conclusion that respondent brought about the circulation of these rumors. Respondent is not to blame simply because his reputation may have led people to believe that his interest in the company would augur well for the price of its stock.

When respondent's purpose is to manipulate, he is guilty of violating Section 9(a) (2), and the provisions of Section 9(a) (6) permitting pegging, fixing, and stabilizing have been held not to save him. The Commission stated that to permit transactions designed to maintain a price that has already been artificially raised, would be to neglect the obvious purpose and intent that underlay Section 9(a) (6) and to make its provisions a means for avoiding the prohibitions of Section 9(a) (2).[313]

Conclusion

It may be safely said that the decisions of the Securities and Exchange Commission rank with the highest type of administrative-judicial process. They exhibit a careful and complete reliance on fact, made possible by exhaustive records and trial examiners' reports. They reflect the maturity and intelligence which marks the Commission's attitude toward the broad purpose of the ramified task entrusted to it. One is tempted to predict that review by the courts will display a deference to the Commission's opinions which their quality deserves. The great variable in the prospect of continued excellence is, of course, the competence and integrity of the public servants who will administer the Securities and Exchange Acts in the future.

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[313] *Ibid.*

Mississippi Law Journal

JOURNAL of the MISSISSIPPI STATE BAR

VOL. X DECEMBER, 1937 No. 1

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NOTE: The names and addresses of all other officers and members of the MISSISSIPPI STATE BAR ASSOCIATION are contained in the September, 1937 issue of the JOURNAL.

STATE BAR SECTION

[EDITOR'S NOTE: *Inauguration of this section follows suggestion of the Commissioners of the Mississippi State Bar that a resume of activities of the bar and its members be included in the Law Journal. Members of the bar may coöperate by submitting items to Mrs. Alice Nevels, Secretary of the Association, New Capitol, Jackson.*]

Failure of the Seventh District to name a commissioner at the recent annual convention in Meridian resulted in the continuance of Fred J. Lotterhos of Jackson, who was not a candidate for reëlection. Since no election was completed by the district members, the Commission at its next regular meeting following the convention held that Mr. Lotterhos should continue in office. The convention election resulted in a tie vote between Harry Bryan of Jackson and Roy Arnold of Jackson.

* * * * * *

A program designed to stimulate interest of the lawyers in the work of the state bar was adopted at the recent meeting of the Commissioners, held in Jackson. Resolutions were adopted authorizing President Marion W. Reily of Meridian to:-

Instruct each commissioner to organize lawyers in his district into county associations and urge monthly meetings; write judges of the state suggesting that court be dispensed with during the annual convention of the state bar, and that leaves of absence be granted those attorneys desiring to attend sessions of the American Bar Association; have secretary submit lists of delinquent members in each district to commissioner of that district, said commissioner to personally contact the delinquent members in an effort to return them to good standing.

* * * * * *

Ben H. McFarland of Aberdeen was reëlected Complaint Commissioner.

* * * * * *

The Junior Bar Section's County Court Committee has been giving excellent thought and work to drafting an amendment to the County Court Chapter (Chapter 17) of the Code. Members are: Hugh N. Clayton, New Albany; H. Edwin White, Lexington; J. H. Holloman, Columbus; W. A. Bacon, Jr., Durant; O. B. Triplett, Jr., Forest; Ben A. Guider, Vicksburg; J. Gordon Roach, McComb; W. A. Beard, Jr., Laurel; and G. B. Cousins, Biloxi.

* * * * * *

One of the important committees appointed by President Reily deals with Pleading, Practice and Procedure, and is composed of Chief Justice Sydney Smith, Justice J. G. McGowen, Justice George H. Ethridge, Judge Arthur G. Busby, Waynesboro; Judge J. F. Allen, Kosciusko; Judge John M. Kuykendall, Charleston; Chancellor R. E. Jackson, Cleveland; Chancellor T. P. Guyton, Kosciusko

ko; Dean T. C. Kimbrough, University; Attorneys W. C. Martin, Natchez; Frank E. Everett, Indianola; J. V. Gipson, Meridian; R. M. Kelly, Vicksburg; H. F. Case, Quitman; E. B. Cooper, Laurel; C. L. Garnett, Columbus; Ross R. Barnett, Jackson; and O. L. Kimbrough, Greenwood.

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Members of the Legislative Investigating Committee have prepared their report for the January session of the Legislature. On this committee are George B. Herring, Canton; J. H. Culkin, Vicksburg; and J. A. Phillips, Macon. The School Survey Committee which includes John W. Kyle, Sardis; M. C. Young, Aberdeen; Hansford L. Simmons, McComb; Thos. L. Bailey, Meridian; and R. T. Jarvis, Booneville, has also been actively engaged at a similar task.

* * * * * *

The United States Junior Chamber of Commerce is realizing the ability of the young lawyers, which has been manifested in the appointment of George Ethridge, A. M. Byrd, Fred A. Ross, Walker Broach, all of Meridian; Webb Overstreet, Jr., Holly Springs; David Cottrell, Gulfport; and Robert Hauberg, Jackson, to various and sundry committees of this organization.

* * * * * *

Meyer Lewis, Jr. recently addressed the Commercial Law Class of Jackson Central High School on "Contracts and Conveyance of Land."

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The firm of Ray and Cook of Jackson, composed of Bob Ray and W. H. Cook, Jr. has dissolved. Mr. Ray has become associated with the firm of Stevens and Stevens of Jackson.

* * * * * *

Important posts to which members of the bar have been named recently are Assistant Attorney-General and member of the State Highway Commission. Russell Wright of Meridian was named Assistant Attorney-General succeeding Wm. H. Maynard, who resigned to return to his private practice at his home in Clarksdale. Mr. Wright resigned as County Attorney of Lauderdale County to accept this position and was succeeded by J. A. Riddell of Meridian, who was appointed by the Governor to fill the interim term.

The other lawyer recognized was Sidney T. Roebuck, new Highway Commissioner from the central district, succeeding the late Brown Williams of Philadelphia. Mr. Roebuck is also Secretary of the Democratic Executive Committee.

* * * * * *

An outstanding member of the bar recently went by plane to New York. Upon leaving he advised his office personnel that he would wire that evening from either New York or Heaven. He received the retort that a wire from either place would be appreciated. That evening the promised telegram read, "Have arrived in

the Beautiful City," and until he returned there was some doubt in the minds of his employees as to his ability to determine which destination he had reached.

* * * * * *

Members of the State Bar attending the American Bar Association Convention in Kansas City, September 27-October 1, were Clyde Hester, Pat Eager, Hubert Lipscomb, W. E. Morse, L. Barrett Jones, B. B. McLendon, Wm. H. Watkins, Robert N. Somerville, R. C. Stovall, Elizabeth Hulen, Attorney-General Greek L. Rice, and Dean T. C. Kimbrough. Mr. Jones is a member of the Board of Governors of the American Bar Association; Mr. Watkins and Dean Kimbrough are members of the House of Delegates; Mr. Stovall and Mr. Somerville are members of the National Conference on Uniform State Laws. Attorney-General Rice attended the Association of Attorney-Generals, of which he is a member.

The secretary of the State Bar attended the section meetings on Bar Organization Activities and the Association of Bar Secretaries securing important information as to the work of other organizations.

* * * * * *

Memorial services were held by the State Bar recently for the late Justice W. H. Cook of the Supreme Court, who died from a sudden heart attack. The program was arranged by President Reily, with J. Morgan Stevens of Jackson, whom Justice Cook succeeded on the bench by appointment of former Governor Lee Russell, in charge. Chancellor A. B. Butts of the University of Mississippi, was the principal speaker, touching on the life of Justice Cook, with special reference to his interest in the affairs of Ole Miss. Justice Cook was a member of the first Ole Miss football team, and one of the scholarly students of the law school.

Governor White attended the services, as did members of Justice Cook's family.

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Sitting in the death-vacated post of Justice Cook is Justice Harvey McGehee of Columbia, who was named to the bench by the governor. In accepting the post, Justice McGehee resigned as circuit judge of the 15th district. Judge J. C. Shivers was appointed as circuit judge to succeed Justice McGehee.

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Other deaths among the legal fraternity since the last annual meeting include: William Hemingway, Professor of Law, University; Joseph H. Penix, Jackson; J. D. Thames, Vicksburg; C. A. Jacquess, Tunica; A. K. Foot, Canton; A. F. Gardner, Sr., Greenwood; J. C. Ward, Sumner; and J. A. E. Pyle, Iuka.

NOTES

The Effect of the Social Security Cases on the Butler Case

In May, 1933, Congress passed the Agricultural Adjustment Act.[1] The plan of this Act was the stabilization of the price of certain basic farm products,[2] by reduction of the acreage of production. This was to be accomplished through voluntary agreements between the government and the producer, the latter to be compensated by the government for his reduced acreage or production, as the case might be. These payments were to be financed through the levying of processing and floor taxes,[3] which were not to be paid into the general treasury, but set aside in a special "earmarked" fund. In this manner, Congress hoped to establish and maintain such balance between the production and consumption of agricultural commodities, and such marketing conditions therefor, as would re-establish prices to farmers at a level that would give agricultural commodities a purchasing power with respect to articles that farmers buy.[4]

In the case of *United States v. Butler*[5] the constitutionality of this Act was questioned. In rendering the decision the court held that, unlike the litigant in *Massachusetts v. Mellon*,[6] the respondent in this case did have a standing in court, because the money did not go for the general support of the government, but was "ear-marked" in advance, and could be spent for only one specific purpose; *viz.*, to defray expenses under the Act. As for the contention that the Act was valid under the constitutional provision to regulate commerce between the several states,[7] the court dismissed this as being irrelevant, since the stated purpose of the Act was the control of agricultural production, a purely local activity.

Mr. Justice Roberts, after explaining fully the constitutionality of taxing statutes levied under the "general welfare"[8] phrase, suddenly stops abruptly and refuses to draw any conclusion therefrom, stating that there is no reason for deciding the scope of this clause, because the Act clearly invades the reserved powers of the states.[9] To quote from the case:[10]

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[1] 48 Stat. 31 (1933), 7 U. S. C. A. § 601 (1936).

[2] Section 11 denominates wheat, cotton, field corn, hogs, rice, tobacco, and milk and its products, "basic agricultural commodities," to which the Act is to apply.

[3] The tax was fixed "at such rate as equals the difference between the current average farm price for the commodity and the fair exchange value."

[4] Section 2 of the Act.

[5] 297 U. S. 1, 56, 80 L. ed. 477, 483 (1936).

[6] 262 U. S. 447, 67 L. ed. 1078 (1922).

[7] U. S. Const. Art. I, § 8.

[8] U. S. Const. Art. I, § 8, cited note 7, *supra.*

[9] The Tenth Amendment, which declares: "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively or to the people."

[10] 297 U. S. 1, 68, 80 L. ed. 477, 489 (1936).

> "The act invades the reserved rights of the states. It is a statutory plan to regulate and control agricultural production, a matter beyond the powers delegated to the federal government. The tax, the appropriation of the funds raised, and the direction for their disbursement, are but parts of the plan. They are but means to an unconstitutional end."

The court then proceeds to the third reason for holding the Act unconstitutional: that the Act coerces the producers to accept this aid of the government. The court assumed the attitude that the amount offered was intended to be sufficient to exert pressure on the farmer to agree to the proposed regulation, and that the power to confer or withhold unlimited benefits is the power to coerce or destroy.

The final reason for holding the Act unconstitutional is that contracts with agriculturalists for the reduction of acreage and the control of production, being outside the range of federal power, cannot justify appropriations and expenditures for such purposes. The court seemed to indicate that if the contract had contained a provision that benefits were to be paid only after certain conditions had been complied with, it might not have been held unconstitutional on this ground.

Thus in this case, the court held that the A.A.A. invaded the powers expressly reserved to the states, without first determining whether Congress was validly exercising a delegated power which only incidentally encroached upon state sovereignty. Let us now look to the *Social Security Cases*, to see if they will add anything to the view expressed in the *Butler* case.

The Social Security Act[11] was passed by Congress in August, 1935. This Act is divided into eleven titles, each of which, it has been said, is capable of standing alone. The purpose[12] of the Act is the collection of taxes throughout the United States from employers and employees (with certain stated exceptions)[13] to provide principally for old age benefit payments and unemployment payments.

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[11] 49 STAT. 620 (1935), 42 U. S. C. A. 301-1305 (1936).

[12] From its preamble it is learned that the Act was passed: "To provide for the general welfare by establishing a system of Federal old-age benefits, and by enabling the several states to make more adequate provisions for aged persons, blind persons, dependent and crippled children, maternal and child welfare, public health, and the administration of their unemployment compensation laws; to establish a Social Security Board; to raise revenue, and for other purposes."

[13] Employment excludes: (1) Domestic service, (2) Agricultural labor, (3) Service on ships on navigable waters of U. S., (4) Service in employ of immediate relations, and service by infant, (5) Federal Government service, (6) Service on interstate carrier, (7) State service, and (8) Service with charitable or religious organizations, *etc.*

The constitutionality of Titles IX and III of this Act was examined in *Charles C. Steward Machine Co. v. Davis.*[14] Title IX levies on employers of eight or more individuals an excise tax of 1% of the total wages for 1936, progressing to 3% after 1937. The tax is to be paid into the treasury of the United States as an internal revenue collection. Against this tax the taxpayer may credit the amount of contributions actually paid by him into an unemployment fund under a state law which has been certified and approved by the Social Security Board, but the total credits may not exceed 90% of the tax. Title III authorizes the appropriation of certain federal sums for the purpose of assisting the states in the administration of their unemployment compensation laws.

Mr. Justice Cardozo, speaking for the majority in this case, found the tax imposed by Title IX to be a valid excise, since it was a tax upon the privilege of employment, applied uniformly throughout the United States. The exemptions did not contravene the due process clause of the Fifth Amendment, because, unlike the Fourteenth Amendment, it has no equal protection clause. The court also held that the tax-and-credit device does not amount to coercion upon the states, because any state laws induced by Title IX may be repealed by the states at will and this Act was not passed to force states to enact unemployment laws but to permit them to do so. Unlike the view of the *Butler* case, the court here maintains that "the statute does not call for a surrender by the states of powers essential to their quasi-sovereign existence,"[15] as set out in the Tenth Amendment, because any dissatisfied state may repeal its unemployment plan at any time.

The constitutionality of Titles II and VIII was questioned in *Helvering v. Davis.*[16] Title II provides for the payment of old-age benefits, subject to certain restrictions, from funds of the general treasury. Title VIII provides for the levying of two taxes, one labeled an income tax on employees, the other an excise tax on employers for the privilege of having individuals in their employ. Both wages and employment are defined in this Title as they are in Title II, so that the same exemptions result. The tax on employees is collected by the employer, who deducts it when the wages are paid. Both taxes go into the United States treasury as internal revenue collections. In construing Title II, the court held that the payment of old-age benefits is within the power of Congress to spend for the general welfare, thus giving full judicial approval to a liberal interpretation of the "general welfare" clause; *viz.*, that it confers on Congress an independent substantive power to tax and consequently to spend for the general welfare, and is not limited by the subsequently enumerated powers.[17] Title VIII was held valid under the decision of the *Steward Machine Co.* case, it being a very similar tax to the one imposed in Title IX.

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[14]57 Sup. Ct. 883, 81 L. ed. 779 (1937).
[15]57 Sup. Ct. 883, 893, 81 L. ed. 779, 791 (1937), cited note 14, *supra.*
[16]57 Sup. Ct. 883, 81 L. ed. 779 (1937), cited note 14, *supra.*
[17]Note (1937) 32 ILL. L. REV. 80, 91.

The appellants contended that Titles II and VIII must be construed together, and, being so construed, exceed the powers delegated to the federal government. But the court found no occasion to consider this argument since each title was held independently valid and capable of standing alone.

The case of *Carmichael v. Southern Coal and Coke Co.*,[18] since it deals with the constitutionality of a state unemployment law, will not be discussed directly, but mention of it will be made herein.

II.

Do the *Social Security Cases* in effect overrule the *Butler* case? Some writers contend that the two decisions can be reconciled; while others maintain that the *Social Security Cases,* while they do not overrule the *Butler* case, limit it to such narrow bounds as to make it almost entirely ineffectual. If we adopt the latter view, we must remember that the court declined to overrule the *Butler* case expressly. Should the court in the future desire to hold any similar act unconstitutional, it might, by citing the *Butler* case, and relying on its reasoning, attain this result. In so doing, the court would be able to reach a holding inconsistent with the *Social Security Cases* without finding it necessary to overrule them, or even seriously to consider them in the opinion itself.

Taking up the most important questions common to both the *Social Security Cases* and the *Butler* case, let us view them in the light of the decisions of these cases. Of necessity, the "general welfare" clause, and "tax and regulation" immediately loom as the basis for arguments growing out of these cases. These will be considered separately.

Helvering v. Davis for the first time in the history of the United States gives full judicial approval to a liberal interpretation of the "general welfare" phrase, in that it confers on Congress an independent power to tax and spend for the general welfare, unfettered by the subsequently enumerated powers. The *Butler* case relied solely on the violation of the powers reserved to the states.[19]

There can be no doubt that the powers of the federal government are those expressly delegated by the Constitution, or those derived therefrom. All powers not expressly delegated to the federal government are reserved to the states.[20] Therefore, the logi-

[18]57 Sup. Ct. 868, 81 L. ed. 811 (1937).

[19]Although interpretation of this clause was given in the Butler case no conclusion was drawn therefrom due to the court's reliance on the violation of the Tenth Amendment. In turn, the Helvering case lays no importance on the Tenth Amendment, for the reason that the state laws do not bind the states irrevocably, but may be repealed at any time. Instead, after intepreting the general welfare clause, the court holds that since the federal government does have the power to tax and spend for the general welfare, there cannot, therefore be a violation of the Tenth Amendment, relying on the Butler case in reaching this conclusion.

[20]U. S. CONST., Tenth Amendment.

cal way to determine the powers of the federal government is to look to the Constitution, to see whether or not such powers have been expressly granted.

The *Social Security Cases* aptly follow this line of reasoning, saying that the federal government derives its powers under the taxing clause of the Constitution, and that it necessarily follows that this power is not reserved to the states. But the *Butler* case, although launching forth on this same train of thought, suddenly changes to a back-hand method of reasoning, and holds that the power is reserved to the states, and consequently cannot be delegated to the federal government.

Thus it seems that the Supreme Court considers agriculture as merely a local question not comprehended within the "general welfare" clause of the Constitution. Yet in the case of *J. W. Hampton Co. v. United States*[21] it had held a protective tariff constitutional.[22] If a protective tariff is not local, how can one, with this case in mind, reach the conclusion that agriculture is local?

The tax levied under the provisions of the A.A.A. was held by the court to be not, in truth, a tax. The court explained that a tax was an exaction for the support of the government, and that the tax in this case was an exaction from one class for the benefit of another. It added that even assuming that this was a tax, it was regulatory in its nature, and therefore unconstitutional. On the other hand, a similar tax levied under the Social Security Act was held constitutional. A great determining factor for this reversal of opinion was the fact that the funds paid into the treasury under the A.A.A. were "ear-marked," while those collected under the Social Security Act were paid into the general treasury.

But why, it may be asked, does the court not recognize the regulatory character of the Social Security Act? The government, if it denied the regulatory aim of this Act, would not be altogether truthful about the matter. Why, then, were the *Social Security Cases* not ruled unconstitutional on the ground that the tax was regulatory? This, of necessity, leads to a short consideration of cases dealing with regulation.[23]

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[21]276 U. S. 394, 72 L. ed. 624 (1928).

[22]Under the view that Congress has the power to levy taxes, duties, imposts, and excises to secure revenue of the general government. Also under the power that Congress has to control commerce. *Cf.* Cincinnati Soap Co. v. United States, 57 Sup. Ct. 764, 770, 81 L. ed. 707, 713 (1937) where the court held: "That Congress has power to levy a tax with the collateral purpose of thereby protecting the industries of the United States is no longer open to doubt."

[23]The cases decided before the Supreme Court are as follows:

License Tax Cases, 72 U. S. 462, 18 L. ed. 497 (1866) involving the levying of excise taxes on lottery and retail liquor businesses, such businesses being prohibited by the laws of many states in the Union. It was held that "there is nothing hostile or contradictory in the acts of Congress to the legislation of the states. What the latter prohibits, the former, if the business is found ex-

The cases that came before the Supreme Court up to 1922 laid down the broad principle that a tax is not coercive or regulatory or a penalty unless it shows clearly on its face that it is such, and

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isting notwithstanding the prohibition, discourages by taxation, the two lines of legislation proceed in the same direction, and tend to the same result."

Veazie Bank v. Fenno, 75 U. S. 533, 19 L. ed. 482 (1869), involved a tax of 10% on circulating notes issued by state banks; the primary purpose of this tax being to discourage state bank-notes, and favor the national banks. The tax was clearly not for revenue purposes. Yet this tax was held constitutional.

McCray v. United States, 195 U. S. 27, 49 L. ed. 78 (1904), upheld a tax of 10c per pound on oleomargarine. The decision rested almost entirely upon the principle that if, on its face, it appears to be a tax, the courts cannot question the motives or purposes of Congress for enacting it.

United States v. Doremus, 249 U. S. 86, 63 L. ed. 493 (1919), upheld the Harrison Anti-Narcotics Act, which was aimed at the complete control of narcotics, due to the incapability of the states, individually, to control the trade. One of the provisions of this Act was the levying of a tax of $1 per annum upon each person authorized as dealer, showing clearly that the tax was not for revenue purposes. But the court held this tax constitutional, saying it could not be invalidated because of the supposed motives which induced it. The dissenting opinion asserts the tax invades the reserved powers of the states.

Child Labor Tax Case, 259 U. S. 20, 66 L. ed. 817 (1922), involved a 10% tax on the annual net profit of an employer who knowingly used child labor. This tax was held unconstitutional, as a penalty, the court saying that taxes for this purpose could not be interposed.

Hill v. Wallace, 259 U. S. 44, 66 L. ed. 822 (1922), a tax of 20c per bushel levied on grain futures. The court held this tax unconstitutional on the ground that it sought to regulate trading in grain futures. It is unquestionable that Congress was trying to regulate trading in grain futures just the same as it desired to stamp out illicit traffic in drugs in United States v. Doremus, *supra*.

Florida v. Mellon, 273 U. S. 12, 71 L. ed. 511 (1927), tested the constitutionality of a statute which provided for a tax on inheritance, with an 80% rebate of amount, if paid under a state inheritance law. Florida had no inheritance tax law, and contended that it was coercion on the part of the national government to make it pass a state inheritance law, and that it was encroaching on the state's sovereign power. But the court held that this tax-and-credit device was constitutional, because it operated uniformly on all states, and did not interfere with the full power of taxation that the state possesses.

Nigro v. United States, 276 U. S. 332, 72 L. ed. 600 (1927), a tax was imposed on narcotics; the Child Labor Case and the Grain Futures Case were cited, the party contending that the tax imposed on narcotics was unconstitutional because it was regulatory on its face. The court held, however, that it was constitutional, basing their decision on the Doremus case which was decided by the Supreme Court before the Child Labor Case and the Grain Futures Case.

J. W. Hampton v. United States, 276 U. S. 394, 72 L. ed. 624 (1928), a protective tariff was levied to enable domestic manufacturers to compete on terms of equality with foreign producers in the local market. This Act was held constitutional under the view that Congress had the power to levy taxes, duties, imposts, and excises to secure revenue for the general government. So long as this is the motive, the existence of other motives in the selection of the subjects of taxation cannot invalidate Congressional action. Another ground for holding this tax constitutional was the power that Congress has to regulate commerce.

United States v. Constantine, 296 U. S. 287, 80 L. ed. 233 (1934), after the repeal of the Eighteenth Amendment, the federal government levied a special tax on dealers selling liquors contrary to state law; *i.e.*, in dry states. The

that only under such circumstances may a court question the motives or purposes which induced it. Yet the *Child Labor Tax Case*,[24] decided in 1922, held that a tax on an individual for knowingly employing child labor was unconstitutional, because it was more in the nature of a penalty than a tax. Reconciliation of this case with the *Bank-note Case*,[25] the *Oleomargarine Case*,[26] and the *Narcotics Case*[27] seems impossible. In the *Grain Futures Case*,[28] the tax was held unconstitutional because it was clearly regulatory on its face. However, in reaching this decision the court completely ignored the *Narcotics Case*. The *Nigro*[29] case, which again tested the Narcotics Act, held the Act constitutional, in spite of the *Grain Futures Case* and the *Child Labor Tax Case*, distinguishing them by petty trivialities. In *United States v. Constantine*[30] the liquor tax in issue was held unconstitutional because it was more in the nature of a penalty than a tax, but this case completely overlooked the *Oleomargarine Case* and the *License Tax Cases*.[31]

The *Butler* case goes even further than any of the cases hereinbefore mentioned, holding the tax unconstitutional because the proceeds of the tax were to be used to regulate, saying that the regulatory nature of the tax was patent upon the face of the Act. Here, it was not the tax itself which was regulatory, but the spending of the tax which was to be used for regulatory purposes. The fact that the regulatory feature of the Social Security Act was not cognizable on its face[32] serves as a ground for distinction between the *Social Security Cases* and the *Butler* case.

Thus, from a review of these cases, we see that no single rule or principle can be drawn from them which will be applicable to all. Rather do they depend upon their individual facts and circumstances. Preceding cases are an aid to the court in deciding a constitutional question under consideration, but they by no means bind it to any principle already defined.

III.

Because of the political pressure brought to bear on the Supreme Court, combined with the individual justices' belief that unemployment was more of a national problem than agriculture, we

court held that the tax was unconstitutional because, although labelled as a tax, the collection of it depended on an illegal act; and furthermore, that it was more in the nature of a penalty than a tax. The court in reaching their conclusion did not consider the Doremus case, and completely overlooked the Oleomargarine Case.

[24] 259 U. S. 20, 66 L. ed. 817 (1922).
[25] 75 U. S. 533, 19 L. ed. 482 (1869).
[26] 195 U. S. 27, 49 L. ed. 78 (1904).
[27] 249 U. S. 86, 63 L. ed. 493 (1919).
[28] 259 U. S. 44, 66 L. ed. 822 (1922), cited note 24, *supra*.
[29] 276 U. S. 332, 72 L. ed. 600 (1927).
[30] 296 U. S. 287, 80 L. ed. 233 (1934).
[31] 72 U. S. 462, 18 L. ed. 497 (1866).
[32] In the recent case of Sonzinsky v. United States, 300 U. S. 506, 81 L. ed. 556 (1937), where Congress was obviously trying to regulate, through the repressive effect of a prohibitive tax, traffic in firearms, the court held that such tax was constitutional, since not regulatory on its face.

have the *Social Security Cases* accomplishing that which the *Butler* case refused to validate. Therefore, although the *Social Security Cases* do not expressly overrule the *Butler* case, but instead tend to reconcile the two by a series of differentiating and distinguishing circumstances, nevertheless, the same effect is brought about.

A possible distinction between these conflicting cases lies in the interpretation and application of the "general welfare" clause. In *Steward Machine Co. v. Davis* the Supreme Court for the first time in the history of this country gave a liberal interpretation to this clause, thus opening a new approach for holding excise tax levies constitutional. The advisability of this step is beyond the scope of this note. It has been so construed, and may be availed of in any similar future problem.

The broad view of the power to spend for the general welfare taken in *Helvering v. Davis* will doubtlessly increase the scope of future federal activity. The holding in this case may justify a growth of federal-state coöperation in matters of national concern. However, the national government need not resort to state aid, in view of the broad construction given the power to spend for the general welfare.

Nevertheless, the following limitation, as expressed in the *Butler* case, is quite obvious: when, by statutory action on the part of Congress, it seeks to regulate matters beyond its control, the statute is unconstitutional if its regulatory features are predominant.

As to the outcome of future tax cases there can be no prediction. However, it is possible to predict the possible modes of explanation open to the court in deciding these cases. If the problem is one of whether the tax, as such, can be used for purposes of regulation, there are two methods of approach open to the court: (1) If the court favors the regulatory tax, it may uphold such tax by relying on *McCray v. United States*[33] or *United States v. Doremus;*[34] or (2) if the court dislikes such tax, it may rule it unconstitutional by following the reasoning of the *Child Labor Tax Case* or *United States v. Constantine.* On the other hand, if the problem is one of regulation by spending, there are likewise two courses open to the court: (1) If it approves the tax, it may hold it valid under the "general welfare" clause;[35] or (2) if the court dislikes the tax, it may declare it void under the Tenth Amendment.[36]

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[33]195 U. S. 27, 49 L. ed. 78 (1904), discussed note 23, *supra.*
[34]249 U. S. 86, 63 L. ed. 493 (1919), discussed note 23, *supra.*
[35]As held in the Social Security Cases.
[36]As held in the Butler case.

RECENT DECISIONS

CONTRACTS IMPLIED IN LAW—STATUTE OF LIMITATIONS.

A creditor of an insolvent bank brought suit against the stockholders for double liability imposed upon them by Section 3815, Code of 1930. The three-year period of limitation was interposed as a defense. HELD: The six year, and not the three-year, period is applicable.[1] The court, in support of its conclusion asserted that this is a written contract with an implied promise to pay or perform and is therefore governed by Section 2292, Code of 1930. *Rather v. Moore*, . . . *Miss.* . . . , 173 So. 664 (1937).

The general problem involved has previously been treated in some detail by the writer in 9 *Mississippi Law Journal* 349. The present discussion, therefore, is confined to the effect of the instant case on the views expressed therein.

Statutory obligations of this nature have been considered in previous decisions[2] and placed under the three-year period of limitation. The cases in which this was done, however, were concerned with the usury statute and the recovery of excessive interest thereunder. The writer has pointed out that the conclusion reached in these decisions is out of accord with the trend of authority in this state relating to the limitation of actions on implied-in-law obligations generally.[3] This departure was attributed to the fact that the courts seem to regard actions for the recovery of usurious interest with some disfavor and hence seek to put such controversies to rest at the earliest possible time. It was further intimated by the writer that the arbitrary limitation of actions on a statutory obligation to three years would likely be confined to usury and kindred penal situations. That prophecy seems amply substantiated by the present case where the court by devious reasoning excused itself from the usury statute analogy.[4]

In a strict legal sense no logical distinction exists between an action brought on a usury statute and one brought under a statute for stockholders' double liability. In each instance the fundamental basis for the obligation is the statute itself. In neither event, does the right of action depend to any great extent upon the circumstances giving rise to the application of the statute. In the writer's opinion the distinguishing feature must lie in the different legislative policies behind the two statutes. The statute providing for the

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[1]The two statutes involved are MISS. CODE ANN. (1930) § 2299 and § 2292.

Section 2299 reads as follows: "Actions on open account or stated account not acknowledged in writing signed by the debtor, and on any unwritten contract, express or implied, shall be commenced within three years next after the cause of such action accrued, and not after."

Section 2292 reads: "All actions for which no other period of limitation is prescribed shall be commenced within six years next after the cause of such action accrued, and not after."

[2]Buntyn v. Building & Loan Ass'n, 86 Miss. 454, 38 So. 345 (1905): "All implied contracts in this state are subject to the bar of three years." *id.* at 456, 38 So. at 345. The same rule was adopted and followed in Beck v. Tucker, 147 Miss. 401, 113 So. 209 (1937), where the court said: "So it is settled in Mississippi that the three-year statute of limitation applies in suits to recover illegal or usurious interest in violation of the six per cent statute." *id.* at 411, 113 So. at 211.

But *cf.* DeSoto County v. Wood, 150 Miss. 432, 116 So. 738 (1928) (Action brought for recovery of statutory salary held barred only after six years). See Note (1937) 9 MISS. L. J. 349 and particularly footnote 7 thereof.

[3]Note (1937) 9 MISS L. J. 349.

[4]173 So. 664, 666 (1937).

recovery of usurious interest is in its nature penal. In keeping with the general policy of our court to discourage penalties, it may well be that the court in furtherance of that policy has employed the statute of limitations as a legal device for reaching the desired result. On the other hand the stockholders' double liability statute has for its purpose the salvaging of all assets possible for the benefit of creditors of an insolvent bank. The court, apparently in sympathy with this policy, lends its aid to the legislature by allowing the creditor the longer of the two periods in which to bring his action.

In order to reach the desired conclusion and yet preserve the authority of the usury decisions the court resorted to some very ingenious, though questionable, tricks of logic. Chief among these was the assertion that the double liability imposed upon the stockholder "is not an implied contract but is a written contract with an implied promise to pay or perform."[5] To say that a stockholder is under a contract to pay a creditor a certain sum of money because a statute imposes upon him that duty is to ignore realities and cause confusion in thinking and analysis. A genuine contract is "a promise, or set of promises, to which the law attaches legal significance."[6] Whether such an obligation be expressed, or implied, the court must find an intention to be bound. On the other hand, an obligation imposed by a statute does not come into existence by virtue of any agreement or apparent willingness to be bound, but is created by law apart from assent or intention. Such an obligation, despite the court's denial thereof, is an implied-in-law obligation.[7]

The effect of the present case on the existing status of the law relative to this problem is a confirmation of the court's tendency to confine the rule that all implied contracts are barred by three years to those cases involving the usury and like penal situations. Conversely, the view announced by the line of cases[8] opposed to that rule is more firmly established. That rule adopts the test that the statute applicable shall be determined by whether the evidence establishing the cause of action is oral or written.[9]

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[5]173 So. 664, 667 (1937).

[6]RESTATEMENT, CONTRACTS (1932) § 1; 1 WILLISTON, CONTRACTS (Rev. ed. 1936) § 1.

[7]Robertson v. Miller, 276 U. S. 174, 72 L. ed. 517 (1928); KEENER, QUASI CONTRACTS (1926) 16; WOODWARD, QUASI CONTRACTS (1913) § 1.

[8]Foote v. Farmer, 71 Miss. 148, 14 So. 445 (1893); Washington v. Soria, 73 Miss. 665, 19 So. 485, 55 Am. St. Rep. 555 (1896); Fowlkes v. Lea, 84 Miss. 509, 36 So. 1036, 68 L. R. A. 925, 2 Ann. Cas. 466 (1904); City of Hattiesburg v. Cobb Bros. Const. Co., 174 Miss. 20, 163 So. 676 (1935).

[9]For origin of this rule, see: Fowlkes v. Lea, 84 Miss. 509, 36 So. 1036, 68 L. R. A. 925, 2 Ann. Cas. 466 (1904) and discussion thereof in Note (1937) MISS. L. J. 349, 352.

ESCROW—INTENTION OF GRANTOR TO DELIVER—ADMISSIBILITY IN EVIDENCE OF ESCROW AGENT'S OPINION.

Grantor executed a deed to the two defendants and delivered it to one Henly, with directions to hand it over to the Bank of West Point for safekeeping and for delivery to the two named grantees on the death of the grantor. Henly testified that the directions of the grantor were definite but that, "She could have called for them and received them from the bank at any time before her death." HELD: There was a valid delivery of the deeds in escrow notwithstanding the agent's opinion. *Beasley v. Beasley*, 177 Miss. 522, 171 So. 680 (1937).

Delivery is a declaration or expression of intent that an instrument shall become binding or go into legal effect;[1] and an escrow delivery is a declaration that the instrument shall go into effect according to its stated terms at a future time or upon the happening of some contingency. In order for there to be a valid delivery in escrow, the deed must be placed with the depositary for handing over to the grantee in such manner as to put it beyond the grantor's control, so that the only remaining essential to be performed in order to give effect to the instrument is the fulfillment of the condition or the happening of the event.[2] A determination of whether or not the deed has been placed out of the control of the grantor is in reality a determination of the intent of the grantor at the time he placed the deed in the hands of the escrow agent.[3] Like all other problems involving intent or state of mind, this question is one of fact; the answer to which is to be derived from all the facts and circumstances surrounding the transaction. Of paramount importance are the actual directions given by the grantor to the escrow agent. These directions may be either written or oral.[4] Thus, the use of the term "escrow" can be extremely beneficial, but it is not absolutely necessary and it is not required that any technical form be used or any definite expression by the grantor be made.[5]

[1]Hall v. Barnett, 71 Miss. 37, 14 So. 732 (1893): "Delivery is a question of intention; and it is deducible from all the circumstances of the transaction."

[2]Roach v. Malone Mercantile Co., 135 Ark. 69, 204 S. W. 971 (1918).

[3]Baker v. Baker, 9 Cal. App. 737, 100 Pac. 892 (1909), holding that the giving over of the deed to the escrow agent does not necessarily constitute an escrow delivery, but that the intention manifest at the time was to govern; Cannon v. Handley, 72 Cal. 133, 13 Pac. 315 (1887); Pathost v. Kind, 86 Cal. 37, 24 Pac. 771 (1890), the court saying that once the delivery was made in escrow it became an irrevocable act and the subsequent acts of the grantor in cancelling the deeds was ineffectual and of no force.

For these reasons, the courts look to, and are governed by, the intentions of the grantor. The intention to be determined is that which is manifest at the time of the delivery, and this time alone.

[4]Viso v. Gullo, 178 La. 8, 153 So. 3 (1934).

Parol evidence may be used to show the intentions of the parties and where the grantor makes statements or expresses himself to some third party before delivery of the deed, this evidence will be admitted to show the intent of the grantor and constitutes an exception to the parol evidence rule. The same reasoning applies to statements which might be made after the delivery of the deed where they will tend to show the intention of the grantor to part with all control over the deed. Jordan v. Davis, 108 Ill. 336 (1883); Noftz v. Noftz, 290 Ill. 36, 124 N. E. 838 (1918).

[5]Roach v. Malone Mercantile Co., 135 Ark. 69, 204 S. W. 971 (1918): "While it is not essential to establish an escrow that parties use the word 'Escrow,' yet when they do employ that term it indicates more clearly than any other word the actual intentions of the parties." Harkreader v. Clayton, 56 Miss. 383, 31 Am. Rep. 369 (1879); State Bank v. Evans, 15 N. J. L. 155, 28 Am. Dec. 400 (1836); Jackson v. Catlin, 2 Johns (N. Y.) 248, 3 Am. Dec. 416 (1820); Gaston v. Portland, 16 Ore. 255, 19 Pac. 127 (1888).

Also, the courts will look to and be aided by any other conduct of the grantor, both before and after the delivery to the depositary, evidencing his intention of relinquishing further control over the deed.[6] In the principal case the grantor gave the deeds to Henly with simple directions to deliver them to the Bank of West Point and for them to deliver them to the grantees on her death.

What evidence will be admitted in determining the intention of the grantor? Should the opinion of the escrow agent who receives the deed be admissible in evidence and be given any weight? The courts on this exact point are not numerous, and they do not agree; some holding the evidence admissible,[7] and others holding that it is not competent.[8] Whether or not the escrow agent would have redelivered will have no effect. The answer to this problem depends not simply on the agent's opinion as to the intent of the grantor, because he might be ready to turn over to the grantor the deeds delivered to him even though he knew that the grantor had once intended to place the deeds outside his control.[9]

The problem here is similar to that in other cases wherein the intent or the state of mind of a third party is the question involved. Here, too, the cases are divided and the authorities are not in accord. One line of cases holds that the opinion of the witness is to be received and credence and weight given to his opinion.[10] Another line of cases holds exactly *contra* and says that the opinion of the witness, as to another person's state of mind or intent, should be excluded.[11]

The jury, in cases of this nature, must necessarily base their decision on the supposed state of the grantor's mind. Since this is so, it would appear that if the escrow agent can be properly qualified and be shown to be free from any interest in the outcome of the case, his testimony should be a valuable aid to the jury and his opinion should be admitted in evidence and given to the

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[6]The conduct of the grantor after the delivery of the deed to the depositary will not change the legal effect of the delivery; but it may be instrumental and helpful to the court in determining what the intent of the grantor was at the time of the delivery.

[7]Johnson v. Johnson, 24 R. I. 571, 54 Atl. 378 (1903). The court admitted and gave much weight to the opinion or understanding of the escrow agent to the effect that the grantor did not lose control over the deed but merely meant for it to be delivered to the grantee in case of the grantor's death. *Cf.* Wilson v. Bridgforth, 108 Miss. 199, 204, 66 So. 574, 576 (1924).

[8]Johnson v. Cooper, 123 Kan. 487, 255 Pac. 1112 (1927); Loomis v. Loomis, 178 Mich. 221, 144 N. W. 552 (1913) (The evidence of the agent in this case was completely excluded).

[9]Wilson v. Bridgforth, 108 Miss. 199, 66 So. 524 (1914). The court in this case asserts that it is not what the depositary thought, or what he would have done if the grantor had demanded return of the deeds but what he had a right to do, that is important on the question of whether the deposit of deeds was such as to vest title in the grantees, on the delivery to them by the depositary of the deeds after the grantor's death. The problem involved here is not simply a factual problem, but is one also involving a question of law.

[10]Kuen v. Upmier, 98 Iowa 393, 67 N. W. 374 (1902); Fitzgerald v. Benner, 219 Ill. 485, 76 N. E. 709 (1906); Spencer v. Peterson, 41 Ore. 257, 68 Pac. 519 (1898) (Where the court admitted the opinion of the third party that there was an intention that a way was to be dedicated); Schmick v. Noel, 72 Tex. 3, 8 S. W. 83 (1888).

[11]Hartman v. Rogers, 69 Cal. 646, 11 Pac. 581 (1886); Lowell v. Hammond Co., 66 Conn. 500, 34 Atl. 511 (1885); Sweet v. Wright, 62 Iowa 217, 17 N. W. 468 (1883).

jury along with the other facts and circumstances of the case.[12] The Supreme Court of Mississippi in the principal case, partially concurs in this view in that it admitted the testimony of the agent; but it immediately adds that it places no credence in, and gives no force to, the admitted opinion of the agent. Since, however, the weight to be given the evidence is primarily one for the jury, or the chancellor to decide upon, the opinion of the appellate court as to the weight of the evidence should have little effect.[13]

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[12]*Cf.* 1 WIGMORE, EVIDENCE (2d ed. 1923) § 661: "The argument has been made that because we cannot directly see, hear, or feel the state of another person's mind, therefore testimony to another person's state of mind is based on merely conjectural and therefore inadequate data. This argument is finical enough and it proves too much, for if valid it would forbid the jury to find a verdict upon the supposed state of a person's mind. If they are required and allowed to find such a fact, it is not too much to hear such testimony from a witness who has observed the person exhibiting in his conduct the operations of his mind."

[13]It will be noted that in the principal case a different factual situation arises in that the grantor did not deliver the deeds to the depositary but delivered them to the intermediate agent to be delivered to the depositary. This fact does not distinguish the case from the cases wherein the deeds were delivered directly to the depositary, since it is the directions given by the grantor to the agent and the opinion of the agent that is dealt with.

INTERPRETATION OF STATUTES — STATUTORY DEFINITION INTRODUCED BY WORD "INCLUDES"—IS IT EXCLUSIVE OR DOES IT MERELY BROADEN THE ORDINARY MEANING?

Defendant was convicted of possessing a growing cannabis or marijuana plant, under Chapter 289 of Laws of 1936, which prohibits the possession of narcotics. Section 2 (14) of the Act reads: "'Narcotic drugs' means coca leaves, opium, cannabis, and every substance neither chemically nor physically distinguishable from them." Section 2 (13) provides: "'Cannabis' includes the following substances under whatever names they may be designated (a) the dried flowering of fruiting tops of the pistillate plant Cannabis Sativa L., from which the resin has not been extracted, (b) the resin extracted from such tops, and (c) every compound, manufacture, salt, derivative, mixture, or preparation of such resin, or of such tops from which the resin has not been extracted." Defendant contends that the word "cannabis" as used in subsection (13) must be limited to the substances set out in that sentence, and cannabis in any other form must be excluded; that therefore the growing plant was not included. HELD: By the use of the word "includes" the legislature clearly indicated that it did not intend subsection (13) as a complete definition, but only as an addition or extension of the word "cannabis," referring to the growing plant as well as to the dry tops and resin. Harris v. State, . . . Miss. . . . , 175 So. 342 (1937).

The decision of this case hinges upon the interpretation of the word "includes" in its relation to the statutory definition of "cannabis." Had there been no attempt to define cannabis, the court would probably have had no hesitation whatsoever in finding the defendant guilty, for the growing plant is considered as cannabis just as is the flowering top and the extract, both by common usage and by dictionary definition.[1] But the legislature saw fit to explain its expressions. "The legislature has the power to define for itself. It may upset the dictionary and give to any word a meaning of its own."[2]

As pointed out by the court, the wording of the statute leaves little basis for the defendant's construction. The word "includes" has a connotation of extension rather than limitation. "'Including' is not a word of limitation. Rather is it a word of enlargement, and in ordinary signification implies that something else has been given beyond the general language which precedes it. Neither is it a word of enumeration."[3] It is significant that the legislature

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[1]See definition in WEBSTER'S NEW INTERNATIONAL DICTIONARY. "Dictionaries, both legal, scientific, and general, may be consulted by the courts, in proper cases, in the construction of a statute. It is indeed quite customary for the judicial tribunals to turn to the standard lexicons for aid in determining the meaning to be assigned to words of common speech or to technical terms." BLACK, INTERPRETATION OF LAWS (2d ed. 1911) 278. The foremost authority on the subject, in referring to the growing plant as well as to the flowering tops, speaks of it as cannabis. Hamilton, *The Pharmacopeial Requirements for Cannabis Sativa* (1912) 1 J. AM. PHAR. ASS'N. 201.

[2]Mathison, Sheriff v. Brister, 166 Miss. 67, 145 So. 358 (1933) (gasoline truck driver delivering gasoline to filling stations for employer on salary basis held a "transient vendor" subject to privilege tax).

[3]*In re* Goetz, 71 App. Div. 272, 75 N. Y. Supp. 750, 751 (1st Dept. 1902) (bequest "of all my personal property," including furniture, plate, *etc.*, the word "including" held not to limit the bequest to the property enumerated after the wording, but to cover all of testator's personal property); Jacksonville Terminal Co. v. Blanchard, 77 Fla. 855, 82 So. 309 (1919); Kennedy v. Industrial Accident Commission of California, 50 Cal. App. 184, 195 Pac. 267 (1920); Achelis v. Musgrove, 212 Ala. 47, 101 So. 670 (1924). For further

used the word "means" in some of its other definitions.[4] Obviously, the court was restricting those words to its own definition and the noticeable change to the word "includes" in the case of other names, such as "Coca leaves" and "Opium" leaves the definite impression that the legislature did not intend to limit the broad language of those definitions. To quote the court in the instant case, "The precaution exercised by the Legislature shows clearly that it did not intend to use the word 'means' synonymously with the word 'includes,' and we think the Legislature carefully made that distinction."[5]

If the plain words of the statute were insufficient to justify the stand taken by the court, a cursory glance at the legislative intent behind the act would provide sufficient vindication.[6] Undoubtedly, the legislature desired to stamp out the cultivation, selling, *etc.*, of narcotics. Cannabis, the growing plant, has the same harmful elements as cannabis, the flowering, fruiting tops, and cannabis, the resinous extract.[7] Cannabis needs no processing in order to be ready for use, and the same effects can be obtained by smoking it at the green stage as at the flowering stage. Hence any reasonable interpretation of the statute leaves the conclusion which the court in the instant case reached;[8]

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authorities on the effect of the use of "includes," see WORDS AND PHRASES (all series) Tit. "Includes."

[4]Section 2, chapter 289, Laws 1936 provides that: "(2) 'Physician' means . . . (3) 'Dentist' means . . . (5) 'Manufacturer' means . . . (9) 'Laboratory' means . . . (14) 'Narcotic drugs' means . . ."

[5]175 So. 342, 344 (1937).

[6]"At the point where the text and extrinsic aids fail to give a definite, sensible solution, the subsidia to be used for reaching a satisfactory result should be the individual, social, and public interests involved in view of the statutory purpose, the traditional law, and an equitable solution of the case at hand. These interests should of course be evaluated by a sound discretion and the moral sense of justice of the judge in the particular case." DE SLOOVERE, *The Process of Statutory Interpretation* (1932) 11 N. Y. U. L. Q. REV. 538, 553.

[7]"No part of the plant, of either the pistillate or staminate, was found inactive, except the stems and seeds and at no stage in its growth, from the flowering to the fruiting, was there any difference in the quality of the extract." Hamilton, *The Pharmacopeial Requirements for Cannabis Sativa* (1912) 1 J. AM. PHAR. ASS'N 201, 203.

[8]To justify his interpretation of the Act defendant had relied on two rules of statutory construction. The first was the maxim *Expressio unius est exclusio alterius*, under which he contended that since the definition of cannabis definitely sets out what comes under that heading, only those things so set out are meant to be included, and the growing plant not having been mentioned, it must not have been intended to come within the purview of the statute. This contention was met by the court simply by the statement that the doctrine "cannot be appealed to here." 175 So. 342, 344. As to this point compare State v. Conner, 7 La. Ann. 379 (1852): "In the construction of criminal statutes the rule is too general and subject to too many exceptions in its application to be allowed to govern"; Swick v. Coleman, 218 Ill. 33, 75 N. E. 807, 809 (1905): "This maxim . . . is useful, and is to be applied only when it appears to point to the legislative intent, and never to defeat the plainly indicated purpose of the lawmaking body"; McFarland v. Mo. K. & T. Ry. Co., 94 Mo. App. 336, 68 S. W. 105 (1902); Forsythie v. Paschall, 34 Ariz. 380, 271 Pac. 865, 866 (1928): "It is used only as an aid in determining the true intent of the legislature"; Simmons v. Suffolk County, 230 Mass. 236, 119 N. E. 751 (1918); BLACK, INTERPRETATION OF LAW (2d ed. 1911) § 89: "Where an interpretation clause provides that a certain word shall include certain things, this does not necessarily exclude all other things besides those enumerated."

The second rule upon which defendant relied is that penal statutes must be

namely, that the act applies to the growing plant as well as to the dry tops and the resin.

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strictly construed, and that "we cannot by judicial construction, or considerations of expediency, supply what is palpably omitted from a statute." 175 So. 342, 344. "The law is that criminal statutes must be strictly construed. Such has been the law from time immemorial." State v. Traylor, 100 Miss. 544, 559, 56 So. 521, 523 (1911), citing BISHOP, STATUTORY CRIMES § 230; State v. Love, 170 Miss. 666, 150 So. 196 (1933). But "The purpose and object of all construction of legislative acts is to get at the intent and purpose of the legislature." Bobo v. Commissioner, 92 Miss. 792, 812, 46 So. 819, 823 (1908).

It is evident that the court, if it wished to decide differently from the present holding, would have as little difficulty in finding a rule of construction to justify its interpretation as this court did in discarding such rules. The legal maxims are used to justify the interpretation, rather than as a means of arriving at the intent of the legislature.

MANUFACTURERS AND SELLERS — INJURY TO PURCHASER BY DEFECTIVE CHATTEL—FERTILIZER.

Appellant bought a sack of fertilizer from one of appellee's agents. In crushing lumps in the fertilizer, he seriously injured both his hands from contact with the substance. Appellant contended that the appellee's failure to give the public notice of its dangerous qualities constituted a violation of its legal duty to the appellant and the general public. HELD: Appellant failed to establish that appellee was a manufacturer. In order to hold appellee liable as a seller the appellant must either establish that the seller himself purchased from a manufacturer whom he knew not to be reputable, or that the chattel was an article of food, drink or medicine to be taken internally. *Cone v. Virginia-Carolina Chemical Corp.*, . . . Miss. . . . , 174 So. 554 (1937).

Formerly it was generally acknowledged that a manufacturer owed no duty of reasonable care to anyone other than his immediate vendee.[1] To this rule of non-liability, however, there arose several exceptions, which are noted below.[2] For many years the general rule persisted, or at least received lip-service from the courts. Any enlargement in the scope of the manufacturer's liability must be attributed to an expansion of the exceptions. The courts have experienced particular difficulty in interpreting the first[3] of the above indicated exceptions. This exception is to the effect that a manufacturer is liable for failure to use due and reasonable care in the preparation of an article intended to preserve, destroy or affect human life. Such articles are sometimes designated as "imminently dangerous." In interpreting this expression many courts reached the conclusion that a manufacturer is liable to third persons whenever he should know that the chattel will become dangerous to human health or safety if not carefully prepared, although it may be quite innocuous if there is no negligence in its manufacture. Such an interpretation leads to a new test of liability quite inconsistent with the general rule announced. We are forced to the strange conclusion that a manufacturer is at once *liable* and *not liable* for negligence in the preparation of his ordinary wares. However, an alternative interpretation of this exception, adopted by many courts, declares that there is no liability unless the chattel is imminently dangerous to human life because of its inherently perilous nature. While such an interpretation would obviously include drugs, firearms, explosives, *etc.*,[4]

[1] Winterbottom v. Wright, 10 Mees. & W. 109, 11 L. J. Exch. 415 (1842).

[2] Huset v. Case Threshing Machine Co., 120 Fed. 865, 57 C. C. A. 237 (1903).

These exceptions are:

a. An act of negligence of a manufacturer or vendor, which is imminently dangerous to the life or health of mankind, and which is committed in the preparation or sale of an article intended to preserve, destroy or affect human life, such as drugs or goods, is actionable by third parties who suffer from the negligence.

b. A manufacturer's act of negligence which causes injury to one who is invited by him to use his defective appliance upon the former's premises may be the basis of an action against the owner.

c. One who sells or delivers an article which *he knows* to be imminently dangerous to life or limb of another without notice of its qualities is liable to any person who suffers an injury therefrom which might have been reasonably anticipated whether there were any contractual relations or not. This exception appears to proceed on the basis of concealed entrapments.

[3] See note 2 *a*, *supra*.

[4] Thomas v. Winchester, 6 N. Y. 397, 57 Am. Dec. 455 (1852) (drugs); Hruska v. Parke Davis & Co., 6 F. (2d) 536 (C. C. A. 8th, 1925) (drugs); Wellington v. Downer Kerosene Oil Co., 104 *Id.* 64, 68 (explosive oil).

the courts have held it to include other chattels which can hardly be termed inherently dangerous.[5] The result is that even under this second and more conservative interpretation of the exception the scope of the general rule of non-liability has been greatly restricted. Today it is virtually impossible to determine what chattels the manufacturer may prepare with impunity.

The more modern tendency abrogates the old general rule of non-liability and substitutes in its place the doctrine that a manufacturer is liable for injuries occasioned by chattels manufactured by him if he knew, or by the exercise of reasonable diligence could have known, that the chattel may become dangerous to life or limb if reasonable care is not exercised in its manufacture.[6] The confusion between the old rule and its exceptions is eliminated by the supersession of this doctrine. This view has been adopted by the *Restatement of the Law of Torts*.[7] The Supreme Court of Mississippi, although at one time holding itself in abeyance as to the conflict in authority,[8] has recently committed itself to the older and outmoded rule which holds that there is no liability unless the chattel is by its nature dangerous even when manufactured with care.[9] It has further said that there is no liability if the product is not used for the general purpose for which the manufacturer sold it.[10]

Although the court in the instant case uses confusing language, it rejects the appellant's contention that appellee was a *manufacturer* and considers him as a *seller*. Nevertheless, in applying the law to the facts, it adopted a rule generally recognized as being peculiar to the manufacturer.[11]

The liability of a *seller* for injuries occasioned to his purchaser in the use of the article sold is based on different grounds. He owes his buyer the duty only of revealing any dangers actually within the former's knowledge. Perhaps if the dealer is actually aware of facts which should put him on inquiry as to the existence of a latent peril, he must use reasonable diligence and intelligence to track down the danger and make it known. But this does not amount to a duty to investigate unless a danger signal is before his eyes. Where he fails to impart knowledge that he has in regard to the article sold, he

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[5] Crigger v. Coca Cola Bottling Co., 132 Tenn. 545, 179 S. W. 155 (1915) (mouse in coca cola); Sheehan v. Menkes, 8 N. J. Misc. R. 867, 152 Atl. 326 (1930) (iron bolt in mince pie); Pillars v. R. J. Reynolds Tobacco Co., 117 Miss. 490, 78 So. 365 (1930) (human toe in tobacco); Nehi Bottling Co. v. Thomas, 236 Ky. 684, 33 S. W. (2d) 701 (1930) (arsenic in "pop"); Tate v. Mauldin, 157 S. C. 392, 154 S. E. 431 (1930) (mouse in coca cola); Culbertson v. Coca Cola Bottling Co., 157 S. C. 352, 154 S. E. 424 (1930) (insect in coca cola); Liggett & Myers Tobacco Co. v. Rankin, 246 Ky. 65, 54 S. W. (2d) 612 (1932) (worm in tobacco); Maddox Coffee Co. v. Collins, 46 Ga. App. 220, 167 S. E. 306 (1932) (defective coffee).

[6] McPherson v. Buick, 217 N. Y. 382, 111 N. E. 1050 (1916).

[7] RESTATEMENT, TORTS (1934) § 395.

[8] Pate Automobile Co. v. Westbrook Elevator Co., 142 Miss. 419, 107 So. 552 (1936).

[9] Ford Motor Co. v. Myers, 151 Miss. 73, 117 So. 362 (1938).

[10] Victory Sparkler & Specialty Co. v. Price, 146 Miss. 192, 111 So. 437 (1937).

[11] "A person buying articles not intended for use constituting food, drink or medicine taken internally but substances intended for use on external objects, such as fertilizers, cannot hold the seller liable for injury resulting from the use thereof if bought by the seller from a reputable manufacturer or dealer."

has been held liable to the vendee,[12] but where there is no such knowledge, a different result has been reached.[13]

The duty to investigate is placed on the manufacturer and not on the seller.[14] This is because the manufacturer is intimate with the nature of the machine he makes. He knows, or is in a position to know, the extent of the physical injury that may follow any defect in the chattel he manufactures. He knows those possible defects that may involve a danger of injury to life or limb and he also knows those points of defect which will result only in an impaired usefulness of the machine. Hence he is liable, not only because he should know of the existence of a defect, but also because he should know whether or not that defect involves an unreasonable risk of inflicting bodily injury to those who may be using the machine. In the case of the seller the situation is different. In many instances he is in no better position than the purchaser to know of such defects.

It may be deduced from the above that the conclusion of non-liability at which the court arrived is justifiable under the state of the authorities. However, the language used will likely result in further confusion regarding the respective duties of manufacturers and sellers. No attempt is made herein to consider the liability of either manufacturer or dealer when an action is instituted on the theory of implied warranty.

Alex Gilliam, Jr.

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[12]Smith v. Clarke Hardware Co., 100 Ga. 163, 28 S. E. 73 (1897); Garvey v. Namm, 135 App. Div. 815, 121 N. Y. S. 442 (1910); J. C. Penny v. Morris, 173 Miss. 710, 163 So. 124 (1936).

[13]Glazer v. Seitz, 35 Misc. 341, 71 N. Y. S. 942 (1901); Slattery v. Colgate, 25 R. I. 220, 55 Atl. 639 (1903); Clement v. Rommeck, 149 Mich. 595, 113 N. W. 286 (1907); Hasbrouck v. Armour & Co., 139 Mass. 357, 121 N. W. 157 (1909); Bigelow v. Me. Cr. Co., 110 Me. 105, 85 Atl. 396 (1912); Gerkin v. Brown & S. Co., 171 Mich. 45, 143 N. W. 48 (1913); Stone v. Vannoy R. R. Co., 153 Ky. 240, 154 S. W. 1092 (1913); Hercules Powder Co. v. Calcote, 161 Miss. 860, 138 So. 582 (1932). See Kilgrease v. Galtney Motor Co., 149 Miss. 703, 115 So. 193 (1928).

[14]Kilgrease v. Galtney Motor Co., 149 Miss. 703, 115 So. 193 (1928), cited note 13, *supra*.

MARRIAGE—ANNULMENT FOR DURESS—EFFECT ON LEGITIMACY OF CHILD BORN THREE MONTHS AFTER CEREMONY BUT BEFORE DECREE OF ANNULMENT.

On suit of the defendant, the marriage between him and the plaintiff had been annulled on the grounds of coercion. Plaintiff subsequently brought a bastardy proceeding against the defendant for support of their child, begotten before the marriage ceremony, and born between the time of the ceremony and the rendering of the decree of annulment. This action was held by the Supreme Court to be improper on the ground that even though the marriage had been annulled, the child was still legitimate.[1] Plaintiff therefore brings the present action against the defendant for support of the child as a legitimate child of the defendant. HELD: Defendant is liable. The Court states that the decision in the previous case that tne child was legitimate is binding on the parties, and reiterates the validity of the holding in that case. *Bass v. Ervin*, 177 Miss. 46, 170 So. 673 (1936).

There is a distinction made at law between void and voidable marriages.[2] This distinction applies, not to the legal consequences of an imperfect marriage, once formally dissolved, but to the status of the parties and their offspring before such dissolution. A void marriage is a mere nullity, and its validity may be impeached in any court, whether the question arises directly or collaterally, and whether the parties be living or dead.[3]

On the other hand a voidable marriage is valid for all civil purposes until a competent tribunal has pronounced the sentence of nullity, upon direct proceedings instituted for the purpose of setting the marriage aside.[4] When once set aside, the marriage is treated as void *ab initio;*[5] but unless the suit for nullity reaches its conclusion during the lifetime of both parties, all proceedings fall to the ground, and both survivor and offspring stand as though the union had been lawful from its inception.[6]

At early common law the effect of considering the marriage void *ab initio* after the rendering of a decree of annulment was to place all parties in a position as if there had never been any marriage of any sort.[7] More recent cases still hold to the original strictness of the common-law rule insofar as the immediate parties are concerned. Thus it has been held in a husband's suit for annulment alleging void marriage, that the wife is not entitled to temporary alimony until marriage is proved valid;[8] a wife seeking alimony has been held not entitled to counsel's fees or alimony;[9] and where the mar-

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[1]Ervin v. Bass, 172 Miss. 332, 160 So. 568 (1933).

[2]2 SCHOULER, MARRIAGE, DIVORCE, SEPARATION AND DOMESTIC RELATIONS (6th ed. 1921) § 1081.

[3]Schneider v. Schneider, 183 Cal. 335, 191 Pac. 533, 11 A. L. R. 1386 (1920); Wiley v. Wiley, 75 Ind. App. 456, 123 N. E. 252 (1919); Davis v. Cummins, 195 S. W. 752 (Mo. 1917).

[4]Owen v. Coffey, 201 Ala. 531, 78 So. 885 (1918); Tyson v. State, 83 Fla. 7, 90 So. 622 (1922).

If parties remarry before decree of annulment, they are guilty in an action of bigamy. Ysern v. Horter, 94 N. J. Eq. 135, 118 Atl. 774 (1922). *Cf.* Mason v. Mason, 164 Ark. 59, 261 S. W. 40 (1924).

[5]Millar v. Millar, 175 Cal. 797, 167 Pac. 394 (1917); *In re* Moncrief's Will, 235 N. Y. 390, 39 N. E. 550, 27 A. L. R. 1117 (1923); BISHOP, MARRIAGE, DIVORCE, AND SEPARATION (1891) § 634.

[6]*In re* Guthery's Estate, 205 Mo. App. 664, 226 S. W. 626 (1920). Steerman v. Snow, 94 N. J. Eq. 9, 118 Atl. 696 (1922).

[7]Price v. Price, 124 N. Y. 589, 27 N. E. 383, 12 L. R. A. 359 (1891).

[8]Sims v. Sims, 122 Miss. 745, 85 So. 73 (1920).

[9]Heinle v. Heinle, 115 Misc. 469, 188 N. Y. Supp. 399 (Co. Ct. 1921).

riage was annulled, marriage settlements[10] and conveyances of property in consideration of marriage[11] have been held to fail.

Should the same rule be applied in determining the status of children born of the parties, or should the extremely strong desire to hold the children legitimate prevail? Here, too, most of the cases continue to apply the old common-law rule. New York has even gone so far as to hold the marriage void *ab initio*,[12] and the children illegitimate in spite of a statute providing that marriages affected by fraud, duress, *etc.*, shall be void from the time their nullity is declared by a court.[13] The effect of decisions of this type has frequently been very harsh.

Because of the stigma attaching to a child characterized by the law as illegitimate, courts have always been strongly inclined to hold individuals born in wedlock, whether purported or actual, legitimate. This strong tendency[14] dates back to the time of Lord Ellenborough.[15] It is well exemplified by statutes passed in many jurisdictions providing that even though a marriage is completely void, the issue will be legitimate.[16] It is not surprising, therefore, to find the court in the instant case so greatly influenced by this feeling that it reaches the same result by judicial decision and without the aid of a statute.[17]

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[10] *In re* Garnett, 74 L. J. Ch. 570 (1905).

[11] Rubin v. Joseph, 215 App. Div. 91, 213 N. Y. Supp. 460 (2d Dept. 1926).

[12] Sleicher v. Sleicher, 251 N. Y. 336, 167 N. E. 501 (1929).

[13] See: Note (1929) 43 HARV. L. REV. 109; Note (1930) 30 COL. L. REV. 877; Comment (1929) 39 YALE L. J. 133. *In re* Moncrief's Will, 235 N. Y. 390, 39 N. E. 550, 27 A. L. R. 1117 (1923) (statutory legitimation of children upon subsequent intermarriage of parents held inapplicable where marriage was later annulled).

[14] Olverson v. Olverson, 293 Fed. 1015, 54 App. D. C. 48 (1923); Illinois Land & Loan Co. v. Bonner, 75 Ill. 315 (1874); Zachmann v. Zachmann *et al.*, 201 Ill. 380, 66 N. E. 256 (1903); Wallace v. Wallace, 137 Iowa 37, 114 N. W. 527 (1908); Ellis v. Ellis, 152 Miss. 836, 119 So. 304 (1928); Libman v. Libman, 102 Misc. 443, 169 N. Y. Supp. 900 (1918).

[15] Rex. v. Luffe, 8 East 193, 198, 103 Eng. Rep. 316, 318 (K. B. 1807): "With respect to the case where the parents have married so recently before the birth of the child that it could not have been begotten in wedlock it stands upon its own peculiar ground. The marriage of the parties is the criterion adopted by the law, in cases of antenuptial generation for ascertaining the actual parentage of the child. For this purpose it will not examine when the gestation began, looking only to the recognition of it by the husband in the subsequent act of marriage."

[16] See, for example: Haddon v. Crawford, 49 Ind. App. 551, 97 N. E. 811 (1912); Cain v. Gray, 146 Ky. 402, 142 S. W. 715 (1912); Succession of Segura, 134 La. 84, 63 So. 640 (1913); Philips v. Wilson, 298 Mo. 186, 250 S. W. 408 (1923); *In re* Martinez's Estate, 181 N. Y. Supp. 907 (Sur. Ct. 1920).

[17] In reaching this conclusion the court relies on AMIS, DIVORCE AND SEPARATION IN MISSISSIPPI (1935) § 30. This section reads in part as follows: "But no matter what other effect a decree of nullity might have on the parties to a voidable marriage it seems that the legitimacy of the children born to such a union would not, in this state, be affected thereby. Because it is provided by statute that 'the decree of *divorce* shall not render illegitimate the children begotten between the parties during *lawful* marriage.' Code 1930, Section 1422. Since a voidable marriage is lawful until annulled, then children begotten during its continuance are legitimate. And since the harshness of the common law rule is opposed to the public policy of the state, as declared by statute, equity, in a nullity of it, should follow the law as declared in reference to divorce decrees." But *cf. id.*, § 39: "The decree should therefore adjudicate the existence of such facts, as may have been shown, which rendered the marriage void or voidable from the beginning, and because of the

As for the actual decision in the principal case, the result is unquestionably correct, due to the fact that the child had been previously declared legitimate in an action brought in a bastardy proceeding,[18] and in the words of the court, "Once legitimate, always legitimate."

John B. Farese

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existence thereof further adjudicate the marriage to be null and void from the beginning."

Although the statute cited by Mr. Amis applies only to a decree of divorce, which ordinarily is quite different in effect from a decree of annulment, yet additional weight is given to the argument by the fact that the Mississippi Legislature has failed to distinguish sharply between a divorce and an annulment. Thus MISS. CODE ANN. (1930) § 1414, in listing the causes for divorce, includes insanity or idiocy, marriage to another person at the time of the pretended marriage and consanguinity. Section 1422, in addition to the selection quoted above by Mr. Amis, also provides that if the decree of divorce is rendered because of a previous marriage of one of the parties the children will then be illegitimate. This seems to imply that except for the specific provisions they would have been legitimate. The Mississippi statutes make no reference to a marriage created through duress.

[18]Ervin v. Bass, 172 Miss. 332, 160 So. 568 (1933).

TAXATION—LIABILITY FOR SPECIAL ASSESSMENTS OF LANDS LATER PURCHASED BY THE UNITED STATES.

Suit to cancel tax lien upon land purchased on March 10, 1922 by the United States from the Anderson Cottonwood District; and also to restrain future levy of assessments against the land. The district was formed under the provision of the California Irrigation Act.[1] Prior to the purchase of the land by the United States, certain bonds were lawfully issued and sold by said district. By statute this land was subject to an assessment each year for the purpose of raising money to retire bonds, or paying the yearly interest thereon, and for other costs, possible benefits conferred on the land. During the years 1923 to 1933, inclusive, assessments were levied by the defendant district through its officers and agents, against the property, and these officers and agents have levied and threatened to levy such assessments yearly for the term of the bonds. HELD: Such levy is unlawful. The purported liens created thereby are void, and the threatened future levy of such assessments must be restrained. *United States v. Anderson Cottonwood District*, 19 F. Supp. 740 (N. D. Cal. 1937).

Since the decision of McCulloch v. Maryland[2] it has been definitely settled that all agencies of the federal government are exempted from state taxation. This includes not only land held for federal purposes, as for public buildings or reservations including the public domain;[3] but also any branch of the bank of the United States.[4] The property of any state may be acquired by the federal government upon making just compensation with or without the consent of the state,[5] and property so acquired is immune from all local taxes not final as charges against the property at the time the United States acquired it,[6] and can only be taxed with the consent of the United States.[7]

For most purposes there is held to be a recognized difference between a tax and an assessment for benefits.[8] The word "taxes" means burdens, charges, or impositions put or set upon persons or property for public uses. On the other hand a "special assessment" is a charge laid upon individual property because the property upon which the burden is imposed receives a special benefit which is different from the general one which the owner enjoys in common with the others as a citizen.[9]

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[1] 2 CAL. GEN. LAWS (1931) art. 3854.

[2] 17 U. S. 316, 4 L. ed. 579 (1819), in which it was held that a statute of the state of Maryland, imposing a tax upon the issue of bills by banks, could not constitutionally be applied to a branch of the bank of the United States within that state.

[3] Van Brocklin v. Tennessee, 117 U. S. 151, 29 L. ed. 745 (1886). The land was purchased for the amount of the taxes thereon, and later was sold for a larger sum. The court held that this land was not subject to taxation by the state of Tennessee, while so owned by the United States. See, also, DeLashment v. McClelland, 152 Miss. 781, 118 So. 904 (1928).

[4] Osborn v. Bank of United States, 22 U. S. 738, 6 L. ed. 204 (1824).

[5] Chappell v. United States, 160 U. S. 499, 40 L. ed. 410 (1876).

[6] United States v. Buffalo, 54 F. (2d) 471 (C. C. A. 2d, 1931).

[7] U. S. CONST. Art. I, § 8; United States v. Buffalo, 54 F. (2d) 471 (C. C. A. 2d, 1931); Van Brocklin v. Tennessee, 117 U. S. 151, 29 L. ed. 745 (1886).

However, an exception to this rule exists where property has been sold by the United States and the only condition remaining is the delivery of the deed.

[8] San Diego v. Linda Vista Irr. Dist., 108 Cal. 189, 41 Pac. 291 (1895).

[9] Walker v. Jameson, 140 Ind. 574, 37 N. E. 402 (1894); Hoge v. Garcia, 296 S. W. 982 (Tex. Civ. App. 1927).

To pay for the opening of a street in the ratio of the benefit or advantages

Thus an assessment for benefits has been held not to be excluded in a constitutional provision exempting certain land from taxation.[10] Since a special assessment is not properly a part of the general taxes, it is not necessary that it meet the requirement that all taxes shall be according to the value of the property taxed.[11]

But however well recognized this distinction may be, courts have uniformly declined to hold that it makes any difference when the liability of the federal government or an agency is concerned.[12] The states, by the acts of cession, covenanted, in effect, that when the federal government should purchase any property they would not make any levy upon it. The power to levy taxes or impose assessments can only be exercised on the governed, and not on the governing power, whether federal or state.[13]

After the purchase of the property by the United States, therefore, the land was no longer subject to have assessments levied against it.[14] But it is generally agreed that if the lien is already in existence and has attached to the land, any purchaser of the property, even the United States, takes the property subject to the lien.[15]

Had any tax liens attached to this property at the time of purchase? In the absence of special statutory provisions it is only where the assessment has been completed, assuming that the property was taxable in the first instance, that any lien will attach.[16] There must be an existing obligation to pay money and under the provision of the statute in the instant case this obligation could not exist since the amount was not to be determined until March of each year.[17] Even though the property might have become liable for the tax no levy had been made, and this is a prerequisite of a lien.[18]

Nugent Shands

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derived therefrom is no burden. Lake Shore & M. S. Ry. Co. v. City of Grand Rapids, 102 Mich. 305, 60 N. W. 767 (1894).

[10]City of San Diego v. Linda Vista Irr. Dist., 108 Cal. 189, 41 Pac. 291 (1895).

[11]Jones v. Holzapfel, 30 Colo. 68, 69 Pac. 511 (1902).

[12]Mullen Benevolent Corp. v. United States, 290 U. S. 89, 78 L. ed. 192 (1933); Bannon v. Burns, 39 Fed. 892 (C. C. W. D. Mo. 1889); Van Brocklin v. Tennessee, 117 U. S. 151, 29 L. ed. 745 (1886); City of San Diego v. Linda Vista Irr. Dist., 108 Cal. 189, 41 Pac. 291 (1895). A collection of cases may be found in (1934) 90 A. L. R. 1140.

[13]Fagan v. Chicago, 84 Ill. 227 (1876).

[14]Mullen Benevolent Corp. v. United States, 290 U. S. 89, 78 L. ed. 192 (1933); Natrona County v. Shaffner, 12 Wyo. 177, 74 Pac. 88 (1903).

[15]Mullen Benevolent Corp. v. United States, 290 U. S. 89, 78 L. ed. 192 (1933).

[16]City of Portland v. Multnomah County, 135 Ore. 469, 296 Pac. 48 (1931).

[17]2 CAL. GEN. LAWS (1931) art. 3854, § 33. Statute provides for bonds, "to be paid from revenue derived from an annual assessment upon the land within the district," and further provides that, "the assessment upon the land is a lien against the property assessed from and after the first Monday in March of each year."

[18]Last Bay Municipal Util. Dist. v. Garrison, 191 Cal. 680, 218 Pac. 43 (1923).

VENUE—ACTION AGAINST JOINT TORT-FEASORS—ONE DEFENDANT "FOUND" IN COUNTY THROUGH COLLUSIVE AGREEMENT BETWEEN HIM AND PLAINTIFF.

Suit against two joint tort-feasors. Defendant Coleman, resident of Tennessee, was "found" in county in Mississippi through voluntary agreement between him and plaintiff's attorney entered into for the express and sole purpose of conferring venue in that county. Joint defendant, a railroad corporation, moved for dismissal of suit against it on grounds that through the collusive agreement between plaintiff's attorney and other defendant it was denied its statutory right to venue. HELD: Suit properly dismissed as to defendant railroad corporation. *Nicholson v. Gulf, M. & N. R. Co.*, 177 Miss. 844, 172 So. 306 (1937).

Venue in actions against two or more defendants is proper in any county or district wherein venue is legally obtainable over any one of such defendants; and the determination of location of suit is at the convenience of the plaintiff.[1] But while this rule exists for the convenience of the plaintiff, he must exercise his privilege in a fair and equitable manner.

Courts have been alert and diligent in preventing joinder of a resident defendant where such joinder was only for the purpose of conferring venue.[2] It has been held that the defendant whose joinder established the venue must be a "necessary" or "material" party, as distinguished from an "unnecessary" or "nominal" party,[3] and where no cause of action is stated against that defendant, or no judgment sought against him,[4] then venue may be changed on application of the other defendants joined. And if the cause of action as against that particular defendant is dismissed after joint defendants have

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[1]Miles v. Wright, 22 Ariz. 73, 194 Pac. 88, 12 A. L. R. 970 (1920); Murrell v. Exchange Bank, 168 Ark. 645, 271 S. W. 21 (1925); Meeks v. Waggoner, 191 Ark. 189, 85 S. W. (2d) 711 (1935); Griner v. Wilson, 181 Ga. 432, 182 S. E. 592 (1936); State *ex rel* Adams v. Murray, 272 N. W. 553 (Iowa 1935); De Bouchel v. Koss Const. Co., 180 La. 615, 157 So. 270 (1934); Indianola Cotton Oil Co. v. Crowley, 121 Miss. 262, 83 So. 409 (1920); Pan-American Petroleum Corp. v. Pate, 157 Miss. 822, 126 So. 480 (1930); Daniels v. Livingstone, 168 Miss. 311, 150 So. 662 (1933); Mississippi Power & Light Co. v. Lowe, 175 So. 196 (Miss. 1937).

[2]Robinson v. Nelle, 10 Cal. App. (2d) 541, 52 P. (2d) 519 (1935); Hawkins v. Brown, 78 Kan. 284, 97 Pac. 479 (1908); Trolio v. Nichols, 160 Miss. 611, 133 So. 207 (1931); Adams v. Guthrie & Co., 113 Neb. 192, 202 N. W. 867 (1925); Guaranty Corp. v. Steigman, 62 N. D. 38, 241 N. W. 291 (1931); Rankin Lumber Co. v. Gravely, 112 S. C. 128, 99 S. E. 349 (1919); Rosamond v. Lucas-Kidd Motor Co., 191 S. E. 516 (S. C. 1937); Hoese v. Whole Wheat Cereal Co., 54 S. D. 143, 222 N. W. 692 (1928).

[3]*Ex parte* Fairfield Amer. Nat. Bank, 223 Ala. 252, 135 So. 447 (1931); Interstate Bond Co. v. Lee, 182 Ga. 238, 184 S. E. 866 (1936); Knox County v. Kelly Adm'rs, 268 Ky. 361, 105 S. W. (2d) 141 (1931); Trolio v. Nichols, 160 Miss. 611, 133 So. 207 (1931); Daniels v. Livingstone, 168 Miss. 311, 150 So. 662 (1933); Winter v. Commercial Bank of New Madrid, 238 S. W. 833 (Mo. App. 1922); Platte Valley Irr. Dist. v. Bryan, 130 Neb. 657, 266 N. W. 73 (1936); Stark County Agr. Soc. v. Brenner, 122 Ohio St. 560, 172 N. E. 659 (1930).

[4]Beal Doyle Dry Goods Co. v. Odd Fellows Bldg. Co., 109 Ark. 77, 158 S. W. 955 (1913); Coca-Cola Bottling Co. v. Swilling, 186 Ark. 1149, 57 S. W. (2d) 1029 (1933); Fleming v. Drake, 163 Ga. 872, 137 S. E. 268 (1927); Maguire v. Peoria & Pekin Union R. Co., 264 Ill. App. 333 (1932); Neice v. Lee, 129 Neb. 561, 262 N. W. 1 (1935); First State Bank of Tuskahoma v. J. B. Klein Iron & Foundry Co., 68 P. (2d) 777 (Okla. 1937); Gorey v. Black,

been brought into the county, then the joined defendants may have the venue changed according to their statutory rights.[5] But the mere fact that judgment is not obtained against the defendant whose joinder established venue is not a sufficient ground for dismissing the action as to the other defendants joined.[6]

The cases are not in accord on what is really the test to apply in determining whether proper venue has been obtained over the defendant whose joinder established venue such as will confer proper venue over other defendants. There is no conflict where there is evident bad faith or fraud on the part of the plaintiff; but the question of whether plaintiff must *actually* have a good cause of action against the defendant whose joinder creates the venue, or merely *believe in good faith* that he has a good cause of action is highly controversial.[7]

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100 Ohio St. 73, 125 N. E. 126 (1919); H. C. Burt & Co. v. Spearman, 19 S. W. (2d) 96 (Tex. Civ. App. 1929).

[5]Barnes v. Balz, 173 Ark. 417, 292 S. W. 391 (1927) (voluntary dismissal); Metcalf v. Hall, 42 Ga. App. 402, 156 S. E. 301 (1930) (voluntary dismissal); Moore v. Atlanta Joint Stock Land Bank, 176 Ga. 697, 168 S. E. 558 (1933) (involuntary dismissal—demurrer by resident defendant sustained); Williams v. Lowe, 49 Ind. App. 606, 97 N. E. 809 (1912) (voluntary dismissal); Nelson v. Sandell, 202 Iowa 109, 209 N. W. 440, 46 A. L. R. 1447 (1926) (involuntary dismissal—directed verdict granted defendant resident—court did not discuss question of venue). Compare the last case with Cox v. Dempsey, 177 Miss. 678, 171 So. 789 (1937) (directed verdict granted resident defendant, court refusing to change venue in absence of bad faith in joining resident defendant). See also Reed v. Renaud, 6 Sm. & M. 79 (Miss. 1846); Christian v. O'Neal, 46 Miss. 669 (1872) [old cases holding voluntary dismissal of defendant resident did not entitle nonresident defendants to change of venue and which were in effect overruled by Gulf Export Co. v. State, 112 Miss. 452, 73 So. 281 (1916)].

[6]McKibben v. Fourth Nat. Bank, 32 Ga. App. 222, 122 S. E. 891 (1924) (resident defendant had good defense through matter in avoidance); Speir v. Floyd, 44 Ga. App. 696, 162 S. E. 874 (1932) (resident defendant interposed a good plea of bankruptcy); Van Buren v. Pratt, 123 Kan. 581, 256 Pac. 1006 (1927) (failure to recover for trespass against resident defendant held not to defeat judgment against nonresident, joined as defendant in good faith); Farmers Grain & Supply Co. v. Atchinson, T. & S. F. Ry. Co., 121 Kan. 10, 245 Pac. 734 (1927) (no recovery against resident defendant because of special statute requiring action against carrier for loss to be brought within four months); Cox v. Dempsey, 177 Miss. 678, 171 So. 789 (1937); Pine v. Superior Court of Seminole County, 172 Okla. 70, 39 P. (2d) 530 (1935) (bona fide settlement made with resident defendant held not to divest court of venue over nonresident defendant).

[7]*Cases following the "Good Faith" rule*: Farmer's Grain & Supply Co. v. Atchinson, T. & S. F. Ry. Co., 121 Kan. 10, 245 Pac. 734, 737 (1927): "If plaintiff brought the action in good faith in an honest belief that it had a cause of action against it, jurisdiction [actually, venue] against the nonresident defendants would not be defeated by the fact that some limitation or other prevented a recovery against the railway company, one of the joint wrongdoers." *Accord*: McClung v. Watt, 190 Cal. 155, 121 Pac. 17 (1922); Mills v. Brown, 205 Cal. 38, 209 Pac. 636 (1928); Pike County Coal Co. v. Farrabee, 79 Ind. App. 210, 137 N. E. 680 (1922); January v. Rice, 33 Mo. 409 (1863); Toland v. Sutherlin, 49 Tex. Civ. App. 538, 110 S. W. 487 (1908); *Cf.* Cox v. Dempsey, 177 Miss. 678, 171 So. 789 (1937).

Cases holding venue depends upon the actual existence of cause of action against the parties necessary to confer venue: Gunroe v. West Virginia Poultry Co-operative Ass'n, 115 W. Va. 87, 174 S. E. 691, 694, 93 A. L. R. 944, 948 (1934): "We are of opinion that the more distinct and better rule, and that probably having the weight of authority behind it, is to the effect that venue

The venue statute under which the instant case arose has an additional feature not generally found in venue statutes. It provides that an action may be brought in any county where the defendant or any of them may be "found,"[8] whereas the general provision in most states is that such action must be brought in the county of "residence" of one of the defendants.[9] Consequently, some complication may arise as to the privilege of a plaintiff in "finding" a defendant. Little difficulty arises when the action must be brought in the county of residence of one of the defendants, since that is a matter of definite ascertainment; but by the very terms of the statute herein involved it may seem that the motives of a plaintiff in "finding" a defendant could not be questioned. Of course, if plaintiff brought a defendant into a county against his will in order to "find" him there, or induced defendant through fraud to come into a county for purposes of venue, the court would hold that there is no venue under such circumstances.

In the principal case there was no fraud or compulsion exercised on the defendant Coleman, "found" in Tishomingo county. He was there through a voluntary agreement entered into for the purpose of conferring venue in that county. Nevertheless, the court held that plaintiff had not secured proper venue of defendant Coleman, such as would permit joinder of defendant railroad. The actual result of the case is that although plaintiff does have the privilege of suing a defendant in any county where the defendant may be present, without regard to the reason for defendant's presence there, yet the plaintiff cannot by his own ingenuity, for the sole purpose of conferring venue over a non-consenting defendant who is to be joined, create the situation whereby the first defendant is "found" in a county.[10] The defendant who had consented would have no reason to complain of the venue which he by his volun-

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depends upon the actual existence of the cause of action, and not upon the mere bona fides of the plaintiff in making his selection of defendants. We believe that making venue depend upon the good faith of the plaintiff based upon a reasonable belief in liability, although we recognize the plausibility of a great deal that can be said in favor of it, would involve the question in uncertainties and speculations that are highly undesirable in dealing with a question so fundamental." *Accord*: Hamilton v. Du Pre, 111 Ga. 819, 35 S. E. 684 (1900); Shomide v. Brewerton, 306 Ill. 365, 137 N. E. 881 (1922); Epp v. Federal Trust Co., 123 Neb. 375, 242 N. W. 922 (1932); Gorey v. Black, 100 Ohio St. 73, 125 N. E. 126 (1919); Mills v. Daubenheyer, 96 Okla. 268, 22 Pac. 523 (1923); City of Sumter v. United States Fidelity & Guaranty Co., 116 S. C. 29, 106 S. E. 778 (1921). See Note (1934) 93 A. L. R. 949 for a discussion of the problem.

[8]MISS. CODE ANN. (1930) § 495. Of course action may also be instituted in the county of residence of any of the defendants. For a case dealing with a somewhat similar situation as the one involved in the instant case, but where action brought in county of residence, see Trolio v. Nichols, 160 Miss. 611, 133 So. 207 (1931). That case reaches essentially the result of the instant case.

[9]The general policy of the statutes relating to venue is to require all suits to be brought in the county where one or the other of the parties resides. 67 C. J. 95.

[10]But see *contra*, Knoxville Banking & Trust Co. v. Mershon, 152 Ky. 169, 153 S. W. 238 (1913). The Kentucky statute provided that an action could be brought in any county where the defendant or any of them may be "summoned." Defendant, resident of Ohio, through agreement with plaintiff, came into county in Kentucky for the sole purpose of conferring venue and allowing joinder of nonresident defendants. Court refused to grant change of venue for other defendants. The court in the instant case mentioned the Kentucky decision and expressly declined to accept its reasoning.

tary acts had conferred over himself, but as to the other defendant, bad faith is shown.[11]

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[11]In the words of the court: "Separate actions may be maintained against joint tort-feasors, and the right to join them in one action is for the convenience of the plaintiff, which he may exercise at his election; but we do not think that by agreement with alleged joint tort-feasor, collusive or otherwise, a plaintiff should be permitted to fix the venue of the cause in any county of his choice, where so to do will destroy a statutory right of a joint tort-feasor as to the venue of the cause against him." 177 Miss. at 853, 172 So. at 308.

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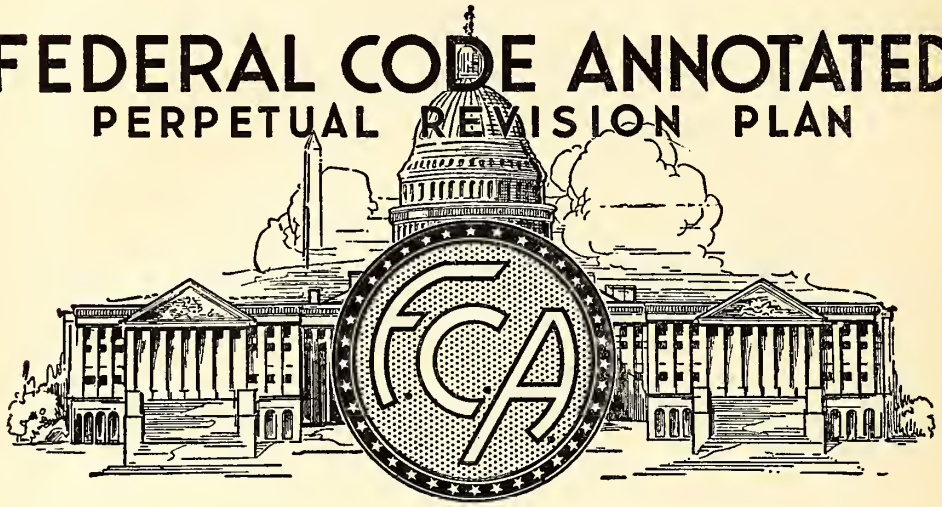

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